

DUE DATE SLIP**GOVT. COLLEGE, LIBRARY**

KOTA (Raj.)

Students can retain library books only for two weeks at the most.

BORROWER'S No.	DUE DATE	SIGNATURE

INTRODUCTION TO ECONOMICS

(Incorporating Indian Economics)

Vol. II

By

Amar Narain Agarwala, M.A.,

*Lecturer in the Department of Commercial Studies,
University of Allahabad.*



Kitab-Mahal, Allahabad.

1940

Copyright—No portion of this book may be reproduced in any form without permission in writing from the publishers, except by a reviewer who wishes to quote brief passages in connection with a review for inclusion in any periodical or newspaper.



Published by Shri Niwas Agarwala, Proprietor,
Kitab-Mahal, Allahabad, and Printed by
Narain Prasad at the Narain Press,
Narain Buildings, Allahabad.

PREFACE

I regard a *preface* the privileged portion of a book wherein the author can unquestioningly use pronouns of the First Person and explain himself in relation to his work. I make its use for this purpose.

The present book, originally conceived as *Science of Economics* three years back, has come out now as *Introduction to Economics*. Its elementary nature accounts for its rechristening. These three years I have largely devoted to repeated revisions, additions, eliminations, and retouching of the manuscripts; and the present form the book, I confess, affords a certain measure of satisfaction to me.

One who attempts to write an elementary book on Economics in the present time certainly assumes an onerous duty. For the twin tendencies of the gradual passing away of the Marshallian sway and the impact of diverse and varying economic principles and theories, have created a fog which it is not easy to look through. As Professor A. C. Pigou very aptly remarked last year: "The situation to-day has nothing in the least resembling the Marshallian rule. There are, indeed, writers with enthusiastic disciples; but they have no less enthusiastic critics. While Marshall was a centre of unity, of acquiescence, of quiescence, they are rather centres of disturbance. To the novice this is a sore trial; he is plunged into controversy on fundamental matters too early; before he has learnt to swim, he is tossed to a turbulent sea." Realising this fact, the practice that I have adopted in the following pages is to steer clear of the controversies spoken of by Prof. Pigou and to focus attention on the essentials in definite tone and language. Where controversies could not be avoided, I have given what appears to me the sanest opinions on the subjects, throwing light on the pros and cons in foot-notes wherever necessary.

I have, however, never lost sight of the fact that Marshall's Economics is still held in unquestionable esteem in our country. To many, nay most, of us, Marshall is the last word in Economics and anything disagreeing with his writings is axiomatically wrong! The theological type of conviction has been extended even to Economics! Indeed, a student who disregards this fact rarely fails to incur the displeasure of his examiners. Written as I have a text-book, I have taken Marshall to be my basis as far as possible; and have drawn upon other authorities against Marshall where absolutely essential and not likely to be questioned. But an elementary book of the Indian standard certainly reduces such occasions to the minimum; and, I believe, student readers will not be sorry in their examination for having read this book.

I can best describe this humble work as *synthesis and compromise of an exhaustive nature*. It need not be said that where even eminent thinkers are sometimes side-tracked, much room does not remain for personal opinions or originality of the author, unless it be in arrangement, expression and general make up. With regard to ideas, I have asserted myself with discrimination and restraint, very often in foot-notes.

A word may also be said about the scope of the book. I have tried to meet the requirements of Intermediate students of various Universities and educational bodies of this country. Wherever there is any departure from traditional text-books in the quantity and selection of matter, it has been dictated by the nature of examination papers. It is a sad confession to make that the prescribed syllabus is very often a poor guide to students in their studies; it is, indeed, in many cases, definitely misleading. A careful scrutiny of examination papers of various educational bodies has unmistakably impressed this truth on my mind. I have, therefore, tried to cover the syllabus as well as the examination papers. Lest I may be misunderstood, I make it plain that I hold no brief for spoon-feeding.

I have liberally depended upon "visual aid" throughout the work. Diagrams, maps and even cartoons have been profusely given so that the ideas expressed in mere language may be lastingly and easily imprinted on the tablet of the reader's memory.

Foot-notes have been given in plenty. I have used them for a large variety of purposes—for giving hints on further reading, for settling controversial issues, for discussing differences of opinion, for showing acquiescence of writers in the views expressed, etc. Foot-notes are certainly more than customary; but they could not be avoided without injuring the utility of the book and my sense of fondness for them.

I have paid special attention to Exchange and Distribution which are stiffest portions of Economics and which are rarely found well-discussed in books. I have attempted to make them simple and exhaustive; and I trust the readers will not probably have very much to complain against them.

I am grateful to the kind teachers of Economics in various colleges who have looked through the Mss. and printed forms of the book; and have made many helpful suggestions. Prominent among them are Professor H. S. Bhargava of Kishori Raman Inter. College, Muttra, Professor R. N. Sanyal of St. Andrews College, Gorakhpur, and Professors Satya Deva Chandpurī and C. P. Srivastava of D. A. V. College, Cawnpore. No less indebted I am to the following gentlemen who have expressed appreciation of my work and found it suitable to their students: Principal S. P. Bhargava, Rajrishi College, Alwar; Professors B. L. Gour and P. D. Saxena, K. P. Inter. College, Allahabad; Professor S. C. Bose, Anglo-Bengal Inter. College, Allahabad; Miss S. Uthup, Chrosthwaite Girls' College, Allahabad; Professor P. N. Tiwari, Govt. College, Allahabad, Professors K. N. Garg and R. S. Agarwala, Agrawal Vidyalyaya Inter. College, Allahabad; Professors L. N. Ghosh and Kashi Prasad, Agra College, Agra; Professor H. L. Puxley, St. John's College, Agra; Professor T. S. Kushwaha, B. R. College, Agra; Professor Sant

Prasad, Radhaswami Educational Institute, Agra; Professor R. G. Sarin, S. D. Inter. College, Beawar; Professor Umarao Singh, U. P. College, Benares; Professor A. C. Sinha, Islamia College, Cawnpore; Professor Gur Prasad, Marwari College, Cawnpore; Professor Raj Narain Mathur, Hindu College, Delhi; Professor Kishan Lal Lad, Anand Inter. College, Dhar, Professor B. N. Kanetaker; Dr. R. B. Seth, D. A. V. College, Dehra Dun; Professor Asthana, Govt. College, Fyzabad, Professor M. B. L. Gupta, Daly College, Indore; Professor R. P. Singh, Maharaja's College, Jaipur, Professor B. P. Vajpeyi, Kanyakubja College, Lucknow; Professor P. K. Banerji, Jubilee College, Lucknow; Professor Triloki Nath, D. N. Inter. College, Meerut; Professor Raj Narain Gupta, S. D. Inter. College, Muzaffarnagar; Professor Rama Shankar Yajnik, Birla College, Pilani; Professor Brij Raj Bihari, Darbar Inter. College, Rewa. To this list I must add the names of my publisher Mr. Sri Niwas Agarwala B. Sc., the proprietor of the Narayan Press Mr. G. P. Tiwari B. Com., typist, and head proof-corrector Mr. Gopal Dass M. A., who have given me ungrudging assistance in all possible ways and looked always to my convenience which has not ever been coincident with theirs.

If the book is found useful also by the students for whom it is meant, I shall think my labour more than amply rewarded.

I most earnestly invite criticisms and suggestions from teachers and *particularly from students* which will receive my immediate attention and deep gratitude.

Dept. of Commerce,
Allahabad University, }
July 10, 1940.

A N. AGARWALA

Contents

CHAP.	EXCHANGE	PP.
I	<u>EXCHANGE</u> . 1 Introduction. 2 Advantages of Exchange 3 Forms of Exchange 4 Barter 5 Sale and Purchase. 6. Exchange Mechanism ..	3-12
II	<u>MARKETS</u> . 1 Introduction. 2. The Evolution of Markets. 3 Types of Markets. 4 Conditions of a Wide Market ..	13-21.
III	<u>DEMAND AND SUPPLY</u> . 1 Demand. 2. Elasticity of Demand. 3 Supply. ..	22-36
IV	<u>THEORY OF VALUE</u> . 1 The Theory of Value 2 The Market Price or the Temporary Equilibrium of Demand and Supply 3 Normal Price or Equilibrium of Normal Demand and Supply 4 Relationship between Market Price, Normal Price and Cost Price 5. Influence of Utility and Cost of Production on Price. ..	37-47
V	<u>MONEY</u> . 1. Money. 2 Metallic Money 3. Paper Money. ...	48-63
VI	<u>MONETARY STANDARDS AND VALUE OF MONEY</u> . 1. Monetary Standards 2. Value of Money 3 Gresham's Law ...	64-79
VII	<u>INDIAN CURRENCY SYSTEM</u> 1 The Present Currency system 2 Improvements in the Currency System of India. 3. History of Indian Currency. 4 The Indian Paper Currency System. 5 History of Prices or Value of Money in India ...	80-94
VIII	<u>CREDIT AND CREDIT MECHANISM</u> 1 Credit 2. Credit instruments 3 Banks 4 Profit and Loss a/c and Balance Sheet of a Bank ...	95-120
IX	<u>INDIAN BANKING SYSTEM</u> 1 Indian money market 2. Indigenous Banking System 3 Modern Banking System 4 The Reserve Bank of India. ..	121-136
X	<u>RURAL INDEBTEDNESS</u> ...	137-141
XI	<u>CO-OPERATION IN INDIA</u> 1 Introductory 2. History of Co-operation in India 3 The Present Position. ..	142-153
XII	<u>TRANSPORT</u> . 1 Introductory 2. Railway Transport in India 3 Road Transport 4 Water Transport 5 Air Transport ..	154-168
XIII	<u>TRADE OF INDIA</u> . 1 Foreign Trade 2. Internal Trade ...	169-181

DISTRIBUTION

I	<u>THE PROBLEM OF DISTRIBUTION</u>	1 Introductory 2 The Problem of Distribution.	... 185—195
• II	<u>MOBILITY OF FACTORS OF PRODUCTION</u>	1 Introductory 2 Mobility of Land 3 Mobility of Labour 4 Mobility of Capital 5 Mobility of Organization 6 Mobility of Enterprise	... 196—209
III	<u>RENT</u>	1 Meaning of Rent 2 Economic Rent and Contract Rent 3 Theory of Rent 4. Rent and Price of Agricultural Produce 5 Factors Effecting Rent, 6 Rents of Building Sites, Mines and fisheries. 7. Unearned Increment	... 210—229
• IV	<u>RENT IN INDIA</u>	1 Applicability of the Ricardian Theory to India 2 Determination of Contract Rent in India 3 Land Tenures in India 4 Land Tenures in U. P.	230—238
• V	<u>WAGES</u>	1 Introduction 2 Determination of Wages 3 Wages Efficiency and Standard of Living 4 Real and Nominal Wages 5 Nominal and Real Cost of Labour 6 Methods of Wage Payment 7 Trade Unions 8 Wages in India	... 239—262
VI	<u>INTEREST</u>	1 Introductory 2 Theory of Interest 3 Net and Gross Interest 4 Relation of Interest to Progress and Rent 5 Interest in India	... 263—277
VII	<u>PROFITS</u>	1 Introductory 2 Gross and Net Profits. 3 How Profit is Determined? 4 Calculation of Profit 5 Profits Tend to fall 6 Profits in India	... 278—288
• VIII	<u>SCOPE FOR ENTERPRISE IN INDIA</u>	1 Scope in Extractive Industries 2 In Manufacturing Industries 3 In Financial Lines 4. In Transport.	... 289—296
✓ PUBLIC FINANCE			
I	<u>DIVISIONS OF PUBLIC FINANCE</u>		... 299—302
II	<u>TAXATION</u>	1. Canons or Principles of Taxation 2. Direct and Indirect Taxes.	... 303—309
III	<u>PUBLIC FINANCE IN INDIA—CENTRAL FINANCE</u>	1 Indian Public Finance 2 Finances of the Govt. of India 3 Heads of Central Expenditure	... 310—321
IV	<u>PROVINCIAL FINANCE IN INDIA.</u>	1 Sources of Provincial Income 2 Heads of Provincial Expenditure 3 Revenue and Expenditure of the Several Provincial Governments for the Year Ended 31st March, 1937	... 322—328
V	<u>LOCAL FINANCE IN INDIA.</u>	1. Municipal Finance. 2. Finances of District Boards. 3. Revenue and Expenditure of District and Local Boards in British India 4 Income and expenditure of Municipalities in India	... 329—334

EXCHANGE

The subject on which we are now about to enter fills so important and conspicuous a position in Political Economy, that in the apprehension of some thinkers its boundaries confound themselves with those of the science itself. One eminent writer has proposed as a name for Political Economy, "Catallactics", or the Science of Exchanges: by others it has been called the Science of Values. If these denominations had appeared to me logically correct I must have placed the discussion of the elementary laws of value at the commencement of our enquiry,

—John Stuart Mill

CHAPTER I

EXCHANGE

Since exchanges of goods regularly increase the utility of the goods exchanged, it is evident that exchange is a part of production and might be treated under that general heading —Ely and Bicker

§ 1. INTRODUCTION

Exchange as a Division of Economics

After studying the Production and Consumption of Wealth, we now come to the study of the next branch of Economics, namely, the Exchange of Wealth. Exchange, as we shall presently see, increases the utility of goods exchanged: it may, as such, be said to be a department of Production. But still it is given a separate treatment because it considers peculiar problems not falling within the proper scope of Production. The central problem of Exchange is the explanation of the determination of value. "Under this title, Exchange," Walker wrote in his *political Economy*, "I would consider the Ratios of Exchange, the terms on which goods, commodities, articles possessing value, items in the sum of wealth, exchange for one another. We are here called to answer the question: why does so much of this commodity exchange for so much of that? Why not for more? Why not for less?"¹

Meaning of Exchange

Exchange as a branch of Economics must be distinguished from the act of exchange. By exchange in the latter sense is meant the lawful, voluntary and mutual transfer of wealth between two parties, each transfer being in return of the other. For instance, if 'A' willingly sells his book to 'B' for Rs. 5, it is an exchange because the transfer of wealth is lawful, voluntary and mutual. But, suppose a thief steals away your watch; this transfer of wealth will not be called an exchange because it is illegal forcible and non-reciprocal—the thief having giver

1. Walker, *Political Economy*, page 79.

you nothing in exchange for the watch. Again, if a man pays Rs. 50 to the Government as fine, the transfer of wealth, though legal, is not exchange because it is compulsory and no corresponding consideration is received by the payer.

Exchange, according to this definition, covers all commercial transactions. When the labourer agrees to work at 8 annas a day, he takes part in a commercial transaction. So does the landlord when he lets his land; for here, too, there is an exchange of the use of land for money. It is the same with the capitalist who lends money at interest; for he supplies one or more people with means of production and accepts payment for doing so. Economics makes these and all other kinds of commercial transactions or acts of exchange, the subject of its investigation under its branch called Exchange.²

Growth of Exchange

In the primitive stage of self-sufficiency, when each family produced all the things it consumed, there was absolutely no necessity of, or the occasion for, the exchange of goods. With the advent of the division of labour and specialization of occupations, the need arose for the exchange of commodities of one producer for those of the other or others³. In modern times exchange has become an indispensable link in the chain of economic activities. Nearly all the wealth that is created to-day is produced for the purpose of being exchanged. The wheat stocked in granaries and the vegetables grown in fields, the cloth woven by weavers and the shoes prepared by shoemakers, are mostly meant for sale and only little for the personal consumption of their producers. 'This is why, when we estimate our wealth, we do not estimate it according to its utility for us, but solely according to its exchange value, i.e., its utility for others.'

2. See N. G. Pierson, *Principles of Economics* (Translated from the Dutch by Wotzel) p. 15.

3. For an interesting history of exchange see Gide, *Principles of Political Economy* (Translated from the French), pp. 184-185.

Theory of Exchange

Every act of exchange implies the following three important factors :—

(a) There must be at least two parties to make an exchange possible: one, willing to part with some article in exchange for the goods which the other party desires to give; and, similarly, the other, willing to accept the article which the former likes to part with, in exchange for the goods he himself likes to give.

(b) Both parties must gain by exchange. A man gives a commodity in exchange for another because the latter is more useful to him than the former. If a man thinks that the thing being given to him in exchange is less useful to him than that he is asked to part with, he will not agree to such a transaction. A cobbler gives his shoes in exchange for wheat because he wants the latter urgently, while the former is almost superfluous to him.

(c) Transactions cease when one of the parties begins to lose as a result of exchange. If the cobbler thinks that he has got all the wheat he requires, he will now prefer to exchange his shoes, not for wheat, but for some other commodity, say, cloth which is more useful to him than wheat.

§ 2. ADVANTAGES OF EXCHANGE

Both Parties Gain in Utility by Exchange

Each party to the exchange, we have seen above, continues to take part in it so long as the article he receives is more useful to him than the corresponding article he has to give in return. Every act of exchange thus brings him a net gain of utility. As soon as the utility of the article offered to him sinks lower than the utility of the article he has to part with in lieu of it, he withholds from entering into the transaction; thus the point at which a net loss of utility might arise is never reached. Exchange is continued so long as it means a gain in utility; and, discontinued as soon as a loss in utility is expected to

make its appearance. This is true of each of the two parties carrying on exchange. Obviously, then, both parties gain in utility by exchange.*

Let us illustrate it by an example. Suppose 'A' has got 9 units of rice and 'B', 9 units of cloth; and both persons are of similar temperament so that the utility of various units of rice and cloth are the same to each of them. The following table shows the utility of successive units of rice and cloth :—

Units	Marginal Utility of	
	Rice	Cloth
1	90	80
2	82	70
3	74	62
4	66	55
5	50	50
6	32	26
7	24	20
8	16	14
9	8	6

4. It was sometimes doubted How can a man gain unless another loses; so that how can both parties to an exchange gain together? The simple explanation of this fallacy has been given above. Professor Gide so lucidly explains it as follows. "If exchange never led to profit, or if every exchange necessarily implied that some one had been cheated, it is difficult to understand why men have persisted for so many centuries in carrying on exchange. In reality, whatever I yield in exchange for something else is always less useful for me, less desirable, and hence worthless, than the thing I acquire. Otherwise I should not give it up. The person who exchanges with me pursues exactly the same line of thought. Each of us thinks that by the exchange he receives more than he gives; and, however strange this may appear, we are both right." Gide, *op. cit.*, p. 198.

In the case of the first transaction, 'A' will give his 9th unit of rice, whose utility is 8; and will get the first unit of cloth, whose utility is 80. His gain in utility is $(80 - 8 =) 72$. Similarly 'B' will part with the 9th unit of cloth, whose utility is 6; and will get the first unit of rice, whose utility is 90. He will, therefore, gain in utility to the extent of $(90 - 6 =) 84$. The first transaction, as such, brings a net increment of utilities to both 'A' and 'B'.

If you calculate the gain in utility to both the parties in successive transactions, you will find that loss begins to appear after fifth transaction when no more exchange will take place. Both the parties must gain in utility as a result of exchange; otherwise, transactions will cease.

// Other Advantages of Exchange

Besides increasing the utility of articles in the possession of both the parties, exchange confers many other benefits as well. Some of them are given below:—

(a) Exchange enables a country to utilize, in the best possible way, the resources which without exchange would remain unused. For instance, we produce cotton more than our requirements and could we not sell it to Japan and Great Britain, it will go to waste. It is exchange, indeed, which enables us to obtain fancy/prices even for that large quantity of wealth which is almost superfluous to us.

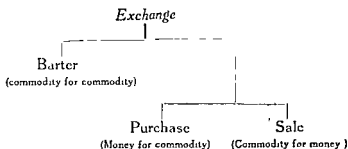
(b) Exchange has made division of labour, in all its forms and phases, an accomplished fact. In the absence of exchange, each man will have to produce all that is necessary to satisfy his wants. If his wants are 20, he will have to carry on 20 different trades, and will become Jack of all but master of none. It is exchange which enables each man to produce things according to his/aptitude rather than to his wants. Similarly, exchange enables each country to produce the things for which it is best fitted. The productivity of each man and each nation is thus maximized by exchange.

(c) Exchange widens our markets and increases the scale of production. The internal and external economies, which large scale production makes possible, reduce the cost, and therefore the price, per unit.

(d) Exchange enables us to get the things which we do not ourselves produce and which we could not otherwise get, for example Parker Fountain pens, motor cars, etc.

§ 3. FORMS OF EXCHANGE

Exchange takes two forms (a) *Barter*, that is, direct exchange of one commodity for another (without the medium of money), as for example, the exchange of wheat for cloth, and (b) *Purchase and Sale*; exchange of a commodity for money is called sale, and exchange of money for a commodity, purchase. The following table elucidates this simple division —



§ 4. BARTER

Barter

Barter, i.e., direct exchange of one commodity for another, was the earliest form of trading. But it was associated with so many inconveniences that it soon disappeared from almost all the civilized countries of the world. It is now to be met with only in economically backward tracts. In our country, it has long ceased to be a common feature of the urban areas. But it still lingers on, to some extent, in rural tracts. In villages, we very often come across a cultivator exchanging his surplus wheat for weaver's cloth, paying for the services of barbers and carpen-

ters in grain, and his son purchasing ink-tablets and writing paper for a handful of rice and wheat. But barter is, on the whole, definitely declining in importance, not only in India, but everywhere in the world.⁵

Conditions Making Barter Possible *

Barter is possible only under very primitive conditions. They are described below :—

(1) *Limited Wants*—Barter requires two persons whose disposable possessions suit each other's wants. This can conveniently happen only if the wants of the members of a community are very few. It becomes increasingly difficult as human wants increase in number and variety. 'A', who wants to give wheat and get milk, may hope to find 'B', who requires wheat and is willing to part with milk. But 'X', who wants to give a watch and get a fountain pen, may not find a man who may be willing to give a fountain pen and take a watch, evidently because fountain pens and watches are not as commonly required and possessed as wheat and milk.

(2) *Limited Area of Exchange*—Barter is possible only if the area of exchange is limited so that the inhabitants may not have to lose much time in finding out the right man for barter. If the area is small, the inhabitants are likely to be acquainted with each other's wants; and, even if they are not so acquainted, much time will not be lost in finding out the proper person.

(3) *General Backwardness of Society*—Barter is possible only under extremely primitive conditions where there is no common medium of exchange, no means of estimating the relative values of two commodities and no method of exchanging goods unless one thing can be immediately transferred and another immediately accepted. Even under primitive conditions barter may be wellnigh impossible if a man's

5. Barter flourishes chiefly among uncivilized communities, or those reduced to severe straits by the operation of a destructive war; though survivals of this method, as well as of many other uncivilized ones, may be seen in the dealings of children with one another. Hadley, *Economics*, page 71.

possessions cannot be subdivided without loss. Suppose a man possesses only a cow: it will be impossible for him to obtain an article of small value by direct exchange.

Obviously, then, the conditions under which barter is possible are, // imaginary rather than real. Professor Cassel's assertion that there has never existed in the history of human life a society normally and wholly dependent upon the exchange of goods without the use of money, seems to have much truth. Inconveniences of Barter


The above account has probably made you look upon barter with a sense of curiosity. Now, try to be a bit reflective and imagine yourself in a society in which barter is the only form of exchange and no money is to be seen. You will surely feel very inconvenient there and will like to come back to your own society where money is used. // If anybody asks you the inconveniences you had to face there, you will probably relate them as under:—

(a) *Want of Double Coincidence*—Barter, you will say, is possible only if a man has to part with a thing which another man wants, and wants the thing which the other has to part with. In other words, *the first difficulty of barter is to find two persons whose disposable possessions suit each other's want*. A hunter having plenty of game may want arms and ammunitions to kill animals, but those who have arms may happen to be well supplied with game so that no direct exchange is possible. This difficulty becomes more prominent and frequent as wants multiply and area of exchange extends.

6. This inconvenience has been faced by many travellers in the primitive countries where barter prevails. We give here Lieutenant Cameron's account (in "*All Across Africa*") of the trouble he had in buying a boat when travelling in Africa. "Syde's agent wished to be paid in ivory, of which I had none, but I found that Mohammed Ibn Seheb had ivory and wanted cloth. Still as I had no cloth, this did not assist me greatly until I heard that Mohammed Ibn Gharib had cloth and wanted wire. This I fortunately possessed. So I gave Ibn Gharib the requisite amount in wire; whereupon he handed over cloth to Ibn Sahib who in his turn gave Syde's agent the wished for ivory. Then he allowed me to have the boat."

(continued on the foot of page 11)

(b) *Want of a Measure of Value*—The second difficulty in barter, you will add, is to determine and remember the rate of exchange. How much milk should be given for a yard of cloth and how much cloth for a pair of shoes? It is difficult to determine how much of any one commodity should be given for a certain quantity of another commodity? There is no common measure of value. In a state of barter, the current price list, if such were prepared, would be a very complicated document, for each commodity would have to be quoted in terms of every other commodity. Between one hundred articles, there must exist no less than 4,950 possible ratios of exchange.

(c) *Want of Means of Sub-division*—The third inconvenience of barter, you will probably continue, is the impossibility of dividing certain goods. A ton of corn and a maund of milk may be portioned out; but what is to be done by a tailor who has a coat ready for exchange? The coat much exceeds in value the bread which he wishes to get from the baker; but he cannot cut the coat up without destroying its value.⁷ 

§ 5. SALE AND PURCHASE

These inconveniences are removed if we find a commodity which acts (i) as a *common medium of exchange* in the sense that every thing is purchased by paying it and sold for it, so that what is obtained by sale in one case may be used for purchase in another; (ii) a *common measure of value* in terms of which we estimate and quote the values of all other goods, so that their values become capable of very easy comparison; and (iii) a *store of value*, so that he may preserve in this from his purchasing power. Such

W. S. Jevons, similarly, relates many interesting cases of a similar nature (in "*Money and the Mechanism of Exchange*"). For instance, when Mr. Wallace was travelling in the Malaya Archipelago, in some of the islands, where there was no paper currency, he could not procure supplies for dinner without a special bargain and much chaffering upon each occasion. If the vendor of fish or other coveted eatables did not meet with the sort of exchange desired, he would pass on, and Mr. Wallace and his party had to go without their dinner!

7. W. S. Jevons, *Money and the Mechanism of Exchange*, pp. 3.6

a commodity is called *money*. In modern times, things are purchased and sold for money; and purchase and sale are the most common forms of exchange.

§ 6. EXCHANGE MECHANISM

Transfer of goods from producers to ultimate consumers now takes place in a roundabout process with the help of many auxiliaries which together constitute the *exchange mechanism*. The chief instruments and auxiliaries of exchange⁸ are the following :—

(a) *Traders*, who bring buyers and sellers in close contact.

(b) The *market* where things are actually bought and sold.

(c) *Money* for or with which things are sold and purchased.

(d) *Means of transport and communication* for sending goods and communicating business conditions from place to place.

(e) *Credit instruments and credit institutions*, i.e., *banks* which manage the transmission of money from place to place.

— — — — —
.

8. They have been discussed in detail in subsequent chapters.

CHAPTER II

MARKETS

The term *market* in *Political Economy* should have reference first to a species of commodity, secondly to a group of exchanges there are as many markets as there are groups of exchanges —Walker.

§ 1. INTRODUCTION

Purchase and sale of commodities, with which Exchange is mostly concerned, take place on a particular spot, popularly called a 'market'. The study of markets, as such, falls under the scope of Exchange. We shall devote the present chapter to a short and scientific study of markets.

Definition

In popular language the term *market* stands for the *actual place*, where purchases and sales are carried on. In Economics, however, this term is used in a different sense. Economists mean by market, not any particular place, but the buyers and sellers of a particular commodity, who are in free competition with one another. For the existence of a market, then, what is necessary is the presence of the (i) buyers, (ii) sellers, and (iii) free competition among them. A market is established wherever a number of dealers in the same commodity, competing freely with each other, are brought together.

The gathering of buyers and sellers at a particular place is not necessary.¹ For, the purpose such a gathering serves can now-a-days be accomplished, to a great extent, by the use of modern methods of communication, e. g., telegraph, telephone, post, etc. Even the physical presence

1. Some old economists define market as a place. E. g., Scager says, "By a market we mean the place or conjunction of means of communication through which buyers and sellers are brought together for the exchange of economic goods." (*Vide, Principles of Economics*, p. 110). Students should safeguard themselves against such a definition.

of the commodity purchased and sold is not essential².

Cournot, a great economist, says, "Economists understand by the term *Market*, not any particular market place in which things are bought and sold, but the whole of any region in which buyers and sellers are in such free intercourse with one another that the prices of the same goods tend to equality easily and quickly."³ W. S. Jevons, another great economist, similarly writes, "Originally, a market was a public place in a town where provisions and other objects were exposed for sale : but the word has been generalised so as to mean any body of persons who are in intimate business relations and carry on extensive transactions in any commodity."⁴

Perfect Market

A market in which perfect competition⁵ prevails is known as a *Perfect Market*. In such a market

2. It must not be supposed from the above account that in the economic sense market is conceived without limits of time or space. Every market is in fact limited by time or space, or both. In Mediaeval Europe, definite days and hours were fixed and definite places assigned, outside which no dealing was allowed in certain goods. But with the modern development of means of communication traders need not be literally assembled to make a market, they may be scattered over a whole large town or over a region of country if by the means of the post office, telephone telegraph and published price lists, they are in close communication. And the more portable the merchandise and efficient the means of communication, the wider can be the range of a market. And many modern markets are continuous in time, only interrupted by Sundays and holidays, and night time. See Devas, *Political Economy*, Bk II, Ch. II. Also Nicholson, *Political Economy*, Bk III, and Flux, *Economic Principles*, Ch III

3 Quoted by Marshall, *Principles of Economics*, p. 324

4 Jevons, *Theory of Political Economy*, pp 84 85

Wicksteed defines the market as the machinery by which objective equilibrium in the marginal significance of exchangeable things is secured and maintained in a catallactic Society. See Wicksteed, *Common Sense of Political Economy*, p. 213.

5. In order to give precision to the term 'Competition' it should be remembered that "there is said to be competition when (a) would be buyers bid against one another, or when (b) would be seller bid against one another. Competition may be one sided or two sided. As one-sided, it is competition between buyers or competition between sellers. As two-sided it is both together." Chapman, *Elementary Economics*, p. 50. Perfect competition means two-sided competition

there is free competition firstly, between buyers and sellers, and secondly, among buyers themselves on the one hand, and sellers themselves on the other. In a perfect market, as will be presently shown, only one price rules for a particular commodity at a particular time.

/ If the market is very large, variations in prices, equal to the cost of transport of goods from one place to another, are to be allowed for. For instance, suppose we get guavas at Allahabad at the rate of six annas a dozen; and the cost of transporting them to Cawnpore is two annas a dozen. Now, if we get guavas at Cawnpore for eight annas a dozen, we will say that Allahabad and Cawnpore are the parts of the same market.

A perfect market does not really exist because perfect competition is a rare occurrence. But a tendency to perfection is certainly discernible. And the more nearly perfect a market is, the greater is the extent of free competition and the stronger is the tendency for the same price to be paid for the same thing at the same time in all parts of the market⁶.

The Law of Indifference or of Markets

Under free competition, if a commodity is perfectly uniform or homogeneous in quality, any portion of it may be indifferently used in place of another equal portion; and in the same perfect market and at the same moment, all portions must be exchanged at the same ratio. There can be no reason why a person should treat exactly similar things differently. If the market is perfect no purchaser will pay for the same commodity more than what is paid by any other purchaser. So long as he gets what he requires, he is indifferent as to who supplies it; and if the selling price of one seller is less than that of another, all purchasers will purchase from him. In the same way no seller will sell an article for a price lower than that obtained by any other seller for the same article. "These facts mean that *in the same open market, at the same time, there can be only one price for the same commodity*. By the same commodity, we mean, of course,

6. See Marshall, *Principles of Economics*, p. 323

a commodity of exactly similar quality, grade and description, any one portion of which may be used or held *indifferently* in place of an equal portion. This tendency or principle is described by Jevons as the *Law of Indifference*. It tends to operate in all markets, but obviously, it is not *exactly* operative in any market. In the first place, perfect competition exists nowhere; and, secondly, the existence of competition itself presupposes certain *temporary* variations in price as between one dealer and another, although the tendency is to fix one price only for one commodity."⁷

§ 2. THE EVOLUTION OF MARKETS

The nature of markets has changed fundamentally through passage of time. The evolution of markets may be looked upon from two standpoints : (1) the Geographical, and (2) the Functional.

The Geographical Evolution

Here we consider the development of markets from the viewpoint of the area occupied by buyers and sellers. There have been three main stages of this type of evolution, namely, the local market, the national market, and the international or world market.

The Local Market—If the buyers and sellers of a commodity extend to a particular locality only, and

7. S. E. Thomas, *Elements of Economics*, p. 168

So far as freedom of contract exists, similar exchanges will be made on approximately similar terms, at least within the limits of the same market, meaning by a market a body of persons in such commercial relations that each can easily acquaint himself with the rates at which certain kinds of exchanges of goods or services are from time to time made by the others. For, it is obvious that, if A prefers a greater gain to a smaller, he will not sell his goods or his services to B at a rate lower than that which he thinks he could obtain from C or D, allowance being made for any trouble, expense or other sacrifice that he would incur in getting the more favourable terms. This inference is often broadly expressed by the statement that "where there is open competition, two prices cannot be permanently maintained in one market for the same commodity." Sidgwick, *Political Economy*, pp. 44-45.

There is another *Law of Markets* as propounded by J. B. Say, which states that, "Every commodity will find a sale more readily with every increase in the variety and abundance of other commodities." Jevons' *Law of Markets* is quite different from Say's Law. See *Guide, op. cit.*

sometimes also to its immediate neighbourhood, the market for it is said to be local. For instance, the market for such perishable articles as milk and vegetables is largely local. Similar is the case with bulky commodities like bricks and sand which cannot be sold to purchasers at distant places, because of the heavy transportation cost. But with the introduction of the "Cold Storage" (which preserves perishable commodities for a sufficiently long period) and cheap means of transport, the market for these commodities is becoming wider.

The National Market—If the purchasers and sellers extend over the length and breadth of the entire country, the market is said to be national. *Dhoties*, caps and probably sola hats have a national market in our country.

The International or World Market—The buyers and sellers constituting this market extend to the ends of the earth. The market of cotton cloth for shirting and suiting, of precious metals and stocks and shares, is international.

The Functional Development

It considers the development of markets from the standpoint of the type of business transacted. The successive stages of evolution, from this point of view, have been the general market, the specialized market, marketing by sample, and marketing by grade.

The General Market is the one where several varieties of a large number of wares and produces are purchased and sold, and which are attended by buyers and sellers of a particular locality and its adjoining areas. A large number of markets in India is of this type.

The Specialized Market—Even in the local or mixed markets, there is some tendency to specialization. With the growth of the industrial and commercial development and the development of the means of transport and communication the need for increased specialization and greater differentiation becomes great. For instance, we have now in Allahabad separate markets for fruits and vegetables; for cloth, and metal wares, and so on, which was not the case in the time of our ancestors.

Marketing by Sample—As the types of goods and the varieties of each type increase, it becomes difficult to display all the stock for sale. Therefore, sellers simply exhibit samples, and later on supply goods conforming to the sample displayed.⁸ Marketing by sample has many advantages. The sample is more easily handled than the bulk. Again, the latter need not be actually transported to the market place. It also enables buyers and sellers to select from a greater variety.

All commodities cannot be sold by this process. It is applicable only to those articles which are uniform in quality and which permit of the separation of a sample. It is quite practicable in case of raw materials, like wheat, and most of the manufactured articles.

Marketing by Grade—Here a commodity is divided into a number of grades according to its qualities, and each grade is given a distinct name or mark. Whenever the seller quotes the price of a commodity of a certain grade, the purchaser gets the correct idea of its quality. Purchasers, therefore, can purchase a commodity even without having a look at the sample—simply by indicating its grade. Pusa No. 12, for instance, is a distinct variety of wheat.⁹

8. Simple and common commodities such as wheat, coal, cotton, wool etc., are usually bought and sold in large quantities and it is obviously impossible for the buyer to inspect every single grain of corn he buys. Definition is obtained jointly in two ways, namely, by grading and by sample. Thus Manitoba wheat is graded as Nos 1, 2, 3 etc. Cotton is graded as fair, middling, low middling etc. A buyer may purchase goods by grade. Later on he might compare the goods supplied with the standard sample represented by that particular grade. If the goods fall short of the standard sample, they can be returned. See Norman Crump, *A First Book of Economics*, pp 20-21.

9 Chapman marks the following stages in the evolution of the market (1) The Localization of markets (2) Dealing by sample (3) Dealing by grade, and (4) Differentiation of markets. (See his *Outlines of Political Economy*, Chapter XII). Nicholson gives the following stages (1) Publicity, (2) Freedom of Trade, (3) Competition prices, (4) Limits of time and place, and (5) Restraint of speculation.

§ 3. TYPES OF MARKETS

Markets may be classified on the basis of space or time.

Space Markets

From the point of view of the space limits of a market, we have local, national and international markets. They have already been dealt with.

Time Markets

Markets also vary according to the period of time which is allowed to the forces of demand and supply to bring themselves into equilibrium with one another. Markets may be classified from this angle of vision and are called time markets. The following classes of time markets may be noted :—

(1) *The Short-Period Market*—Here the supply is limited to the stores which happen to be at hand. Therefore, in the equilibrium of demand and supply, the demand plays a more important part than the supply.

(2) *The Long-Period Market*—If the period is longer than a day or so, the supply will be influenced, more or less, by the cost of producing the commodity in question.

(3) *The Very Long-Period Market*—If the period is very long, this cost will, in its turn, be influenced, more or less, by the cost of producing the labour in the material things required for producing them.¹⁰

This division will be more clear to the reader after he has studied the theory of value.

§ 4. CONDITIONS OF A WIDE MARKET

The market for a commodity may be wide or narrow. The conditions which make the extent of any market large can be divided into two broad classes : (a) Conditions prevailing within the country; and (b) Qualities of the commodity.

10. Marshall. *Principles of Economics*, p. 330.

A. Conditions Within the Country

(1) *Efficient Means of Transport and Communication*—Efficient means of transport, like good roads, railways, steamships and air transport, make the carriage of goods over long distances easy, cheap and quick. Similarly, efficient means of communication like the post, telegraph, telephone and wireless systems, enable traders of one place to get information about the business conditions prevailing at distant places; so that they sell goods to, or purchase them from, the latter as the profit conditions warrant. If means of transport and communication are so poor that the carriage of goods or news involves much cost, time and difficulty, markets must naturally be narrow. Means of transport and communication are, indeed, very potent instruments in widening the area of a market.

(2) *Peace, Order and Security*—Sellers will be willing to send their goods to distant places only if they are sure that they will not be stolen away by thieves, or otherwise damaged, in transit; that their monetary claims will be duly met with, and, if not, the court will help them to realise their dues. The large extent of modern markets would have been unthinkable but for the maintenance of law and order in the countries of the world.

(3) *Efficient Currency and Banking System*—A stable monetary system is absolutely essential for assuring business men that their calculations will not be upset by any outside intrusive force which currency manipulations may let loose. Again, the existence of banks with a network of branches extending over the entire globe, facilitate the making of payments to any place in the world and thus widen the area of markets.

B. Qualities of the Commodity

The wideness of the market also depends upon the qualities of a commodity. The commodities possessing the following qualities usually have very wide markets:

(1) *Universality of Demand*—All those commodities which are universally demanded have very wide

markets. Cotton, wheat, and iron satisfy the wants that are urgent and universal and, therefore, have international markets. The market for the furs, on the other hand, is considerably narrow because they are of little use in warm countries.

(2) *Suitability for Grading and Sampling*—Commodities which can be easily and exactly graded or represented by samples have, other things being equal, wide markets. Cotton, wheat and other staples possess this quality, so that they can be bought and sold by persons at a distance from one another just on the basis of samples or grade. Were the examination of the entire mass of these commodities before purchase essential, their markets would have been very narrow, indeed.

(3) *Portability*—Commodities, for which there is a very wide market, must also be such as will bear a long carriage: their value must be considerable in proportion to their bulk. The market for common bricks is practically confined to the neighbourhood of the kilns in which they are made: they can scarcely ever bear a long carriage by land to a district which has hardly any kilns of its own. On the other hand, the value of gold and diamonds, silk and sares, is so large that small cost of transport does not increase their price appreciably, and, therefore, does not matter.

(4) *Durability*—Perishable and fragile articles cannot enjoy very wide markets because they cannot be transported over long distances. Fish and vegetables have local markets; gold and cotton, world-wide markets.

(5) *Adequacy of Supply*—The supply of a commodity must be adequate to meet a large demand if it is to enjoy a wide market. Only a very restricted market exists in curiosities and rare works of art, whose supply is extremely limited.

CHAPTER III

DEMAND AND SUPPLY

While the individual desire is fitful, the resultant of the desire of all the purchasers is relatively steady,—just as, in physics, the forces of the individual molecules of the atmosphere which bombard our bodies are variable and fitful but the aggregate resultant atmospheric pressure is a steady fifteen pound per square inch — *Fisher*

It was said in the middle of the last century, we are reminded by Henry Clay, that you can make a good economist of a parrot by teaching it to repeat the words "Supply and Demand." A great many people have acted on this belief, and having taught themselves to repeat, like parrots, the words "Supply and Demand," have set up for economists !¹ Be that as it may, the Demand and Supply Formula is to-day the core of the whole edifice of the Science of Economics. Things and services are sold for a price which is determined by the interaction of the forces of demand and supply.² The present chapter shall be devoted to the study of these important forces.

§ 1. DEMAND

Definition

A desire for anything, we must remember, is not the same thing as a demand for it. 'If wishes were horses, then beggars might ride !' By demand economists mean the '*effective*' desire, i. e., the desire which may be satisfied by virtue of the possession of the means of its satisfaction. In other words, desire must be coupled with purchasing power in order to become demand.³ A poor man may like to possess a grand bungalow, an aeroplane and many other

1. Clay, *Economics for the General Reader*, p. 292.

2. The Theory of Demand and Supply has been beautifully summed up as follows "The Supply of a commodity is the quantity offered for sale. Demand is the quantity that will be bought at a certain price. The price tends to make Demand and Supply equal. The competition of sellers makes prices fall, while the competition of buyers raises them."—*Cornah, Simple Economics*, p. 14.

3. For a lucid account see Turner, *Introduction to Economics*, p. 154.

costly things; as he is too poor to purchase them, his desire for them is not demand. But if he wins a Derby prize, he will get the wherewithal to purchase these things. Then his desire will become 'effective' and will, then, be called demand.

Besides possessing the means of acquiring the object of desire, a man must also have the *willingness to part with the means in exchange* for it. A man may possess the means to purchase an article but he may not like to part with the means in order to possess it. A miser may like to have a car for his son, but his attachment to money may prevent him from purchasing it.

Demand may, then, be defined as the (1) desire to possess a thing, coupled with (2) the means of purchasing it, and (3) the willingness to use those means for the purpose. As Ely and Wicker put it, "In order that there may be a demand for a thing, there must be not only a *desire* for it, but also the *willingness* and the *ability* to offer for it some sacrifice."⁴

Demand is always made by a buyer or would-be buyer for a certain article. The demand for a commodity is closely related to its price. The willingness of people to buy a thing, depends, to a considerable extent, upon what they have to pay for it. Therefore, there is no such thing as demand apart from price.⁵ Because of this intimate relationship between demand and price, demand is variously defined as the quantity of a commodity which a person is willing to buy at a certain price.⁶ This definition is very widely popular amongst economists.

Demand Price

By demand price is meant the price at which a purchaser is willing to purchase a certain quantity of

4. Ely and Wicker, *Elementary Principles of Economics*, p. 97.

5. Penson, *The Economics of Everyday Life*, Part I, p. 107.

6. J. S. Mill says that we must mean by the word demand, the quantity demanded, and remember that this is not a fixed quantity, but in general varies according to the value. See his *Principles of Political Economy* III, ii, 4.

a commodity. If you are willing to buy five fountain pens for Rs. 2 each, your demand price is Rs. 2 per fountain pen.

The Law of Demand

The law of diminishing utility tells us that as the stock of a thing increases, its marginal utility, other things remaining the same, decreases. We also know that the price that a person is willing to offer for a commodity is equal to its marginal utility to him. Therefore, as the quantity offered for sale increases and its marginal utility decreases, the price which a buyer is willing to pay for its successive units goes down. In the words of Marshall, "The greater the amount to be sold, the smaller must be the price at which it is offered in order that it may find purchasers; or, in other words, *the amount demanded increases with a fall in price, and diminishes with a rise in price.*"⁷ Demand and price are, as such, indirectly related. This is called the *Law of Demand*. Demand and price are like the two ends of a see-saw; when the one end goes down, the other one goes up; and *vice versa*. The following diagram⁸ illustrates the point very lucidly :—

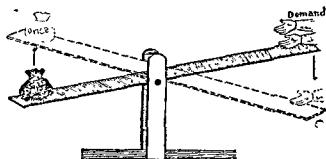


Figure illustrating Law of Demand

Demand Schedule

To obtain complete knowledge of a person's demand for anything at a particular place and time, we have to ascertain how much of it he

7. Marshall, *Principles of Economics*, p. 99.

8. I am thankful to Mr. P. L. Garg (A. V. Inter College, Allahabad) for a skeleton of this diagram.

would be willing to purchase at each of the prices at which it is likely to be offered. A list or schedule showing the amount of the commodity which a person will demand at various prices may be prepared. Such a list or schedule is called *Demand Schedule*. A demand schedule may be defined as *a list showing the relationship between different quantities of a commodity and their respective demand prices at a particular place and time.*

A demand schedule may refer to the demand of an individual or to that of a market or a society. In the latter case, it refers to the collective demand of all the individuals constituting the market or society.

The following is the demand schedule of a student for, say, red-blue Othello pencils at Allahabad on June 1, 1940 at 8 A.M. :—

Demand Schedule

PRICE	DEMAND
6 pice	3
5 pice	4
4 pice	6
3 pice	9
2 pice	12
1 pice	18
Total	52
Demand Curve	

The demand schedule can be represented on a graph paper. Such a graphic representation of demand is called the *Demand Curve*. It reports the number of units that would be brought at different prices. The

above demand schedule is diagrammatically represented below :—

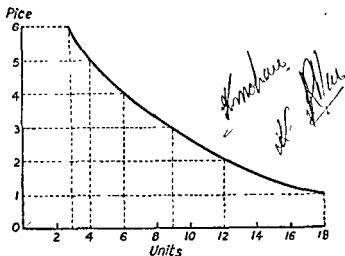


Figure Showing the Demand Curve

Fallacy of Demand and Price Relationship

Sometimes students are confused by such fallacies as this, "If price rises, demand diminishes, but if demand diminishes price falls. It is difficult to see how price ever changes."

According to the law of demand if price rises, demand diminishes and if demand diminishes, price falls, *provided other things remain the same*. If other things really remain the same in actual life, it will certainly be difficult for prices to change to any appreciable degree. But the hard fact is that other things are not always the same and this is responsible for price variations.

If price rises, demand ordinarily diminishes. But in certain cases it may not happen so. Suppose the price of Gandhi caps increases. This will ordinarily cause a fall in demand. But if Mahatma Gandhi is visiting this particular locality and nobody is permitted to see him unless he wears a Gandhi cap, the demand for caps may rise in spite of the fact that their price has gone up. Take another case. Suppose animals of a particular place suddenly begin

to suffer from epidemic diseases and their meat becomes unfit for human consumption. Meat-eaters may, then begin to demand more fish than before, even if its price rises. In these cases, the law of demand is clearly violated. Why? Simply because other things are not the same the utility of Gandhi caps and fish has increased.

If demand diminishes, price ordinarily falls. But if the supply also falls simultaneously at the same rate at which the demand falls, the price may remain unchanged; and if the supply falls at a faster rate than demand, price may even increase. In this case, again, the law of demand is infringed because other things have not remained the same: conditions of supply have changed.

§ 2. ELASTICITY OF DEMAND

Meaning of Elasticity of Demand

The demand for a commodity diminishes, other things being equal, with every increase in the supply of that commodity. But this diminution may be slow or rapid. By the common experience of all merchants when the prices of certain goods are lowered even slightly, there is an appreciable increase in the quantity demanded; and when the prices of these commodities go up, there is a marked decrease in the demand. In the case of other goods, like salt, the amount demanded is little affected by the movement in price. *The variation in demand in response to a variation in price is called the Elasticity of Demand.*

In the words of Marshall, "The elasticity (or responsiveness) of demand... .. is great or small according as the amount demanded increases much or little for a given fall in price, and diminishes much or little for a given rise in price."⁸

Take the case of some good shirting cloth, which is being sold at 8 as. per yard. If the price suddenly drops down to 6 as. per yard, you may like to purchase it for two shirts rather than for one only. In this case, the amount demanded increases much for a small fall in price: price falls by 25 per cent, but

8. Marshall, *Principles of Economics*, p. 102.

the demand rises by 50 per cent; in other words, the rise in demand is more than proportionate to the rise in price. Similarly, if the price of the cloth rises by a small amount, the demand will fall considerably, *i. e.*, more than proportionately. Hence the demand for it is *very elastic*. Articles of luxury generally fall under this category

Take, again, the case of salt. Salt is indispensable for us and our demand for it remains, more or less, the same irrespective of fluctuations in its price. Suppose, its price to-day is one anna per seer, if tomorrow it rises to two annas per seer, our demand for it will probably not decrease appreciably. In other words, the fall in demand is less than proportionate to the rise in the price. Similarly, the fall in price will cause less than proportionate rise in demand. The demand in this case has very little elasticity, so much so that it is said to be *inelastic*. Articles of necessity usually belong to this class.

We have seen above the cases in which the demand varies more, or less, than proportionately as a result of a change in price. There are, however, some articles whose demand varies *in exact proportion* to the variations in price: if price becomes double, the demand falls by half, and *vice versa*. Demand, in such cases, is said to be *elastic*. This is the case, with articles of comfort

The Measure of the Elasticity of Demand

Economists measure the elasticity of demand by assuming one ('1') as the unit of elasticity. The elasticity ('e') of the demand for a commodity is said to be one ('1') when demand changes proportionately with a change in price. Thus, if price becomes double, the demand becomes half; if price falls by 50 per cent, the demand rises by the same percentage. Here the total amount spent on the article (price per unit \times the number of units purchased) always remains the same irrespective of price fluctuations. This is the case with articles of comforts. The elasticity of demand for such articles is expressed symbolically as below :—

$$e = 1$$

The elasticity of demand for a commodity is said to be more than one (1) when the change in demand is more than proportionate to the change in price. Thus, if price falls by 10 per cent, the demand may rise by 20 per cent, and *vice versa*. In this case the total amount spent on the commodity diminishes if the price rises, and increases if the price falls. This is the case with articles of luxuries. The elasticity of demand for such articles is expressed symbolically as below :—

$$e > 1$$

The elasticity of demand for a commodity is said to be less than one (1) when the change in demand is less than proportionate to the change in price. Thus, if price falls by 20 per cent, the demand may rise by only 2 per cent, and *vice versa*. In this case, the total amount spent on the commodity increases when price rises, and falls when price sinks. This is the case with necessities. The elasticity of demand for such articles is expressed symbolically as below :—

$$e < 1$$

The following chart tabulates the above discussion in a brief form :—

Degree of change		Symbol of elasticity	Articles falling under each.	Degree of elasticity.
a	Proportionate,	$e = 1$	Articles of comfort	Elasticity
b	More than proportionate.	$e > 1$	Articles of luxury.	High elasticity
c	Less than proportionate.	$e < 1$	Articles of necessity	Inelasticity.

Chart Explaining Elasticity of Demand. /

Curve to Show Elastic Demand

The demand for cars is elastic.⁹ The following is the Demand Schedule for cars :—

9. The elasticity of demand for cars is fairly small for an individual. However cheap cars may become, nobody will renew his car or cars more than once a year. But it is fairly large for the public as a whole. Every time the price falls, a new stratum of buyers comes up to purchase cars

Demand Schedule (for cars)

Price Rs.	No. Demanded
10,000	1,000
8,000	3,000
5,000	8,000
4,000	11,000

The resulting curve (see below) gives the typical demand curve for such articles. The curve tends to be horizontal.

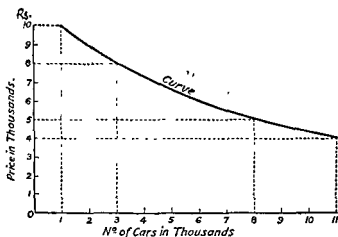


Figure Showing Elasticity of Demand for Cars.

(Note—Mark the horizontal nature of the curve).

Curve Illustrating Inelastic Demand

Below is given the demand schedule for salt. The demand for salt, as said above, is inelastic.

Demand Schedule (for Salt)

Price (Rs. per maund)	Quantity Demanded (Maunds)
6	100
4	110
3	115
2	120

The resulting curve (see below) gives the demand curve for salt. The curve tends to be vertical.

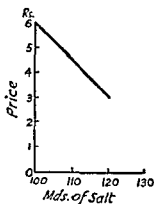


Figure Showing Inelasticity of Demand for Salt.

(Note—Mark the vertical nature of the curve)

Conditions Governing Variations in Demand

The following are the chief general conditions which determine elasticity of demand for any commodity :—

(1) *The Demand for Luxuries is Elastic while that for Necessaries, Inelastic*—The reason for it is that certain things, which are essential to life, will be obtained at any price; whereas luxuries can be more easily dispensed with.

The demand for necessities for existence is so pressing that a man may be prepared to spend his all rather than go without them. The demand for conventional necessities is also difficult to be put off. On the death of a member of his family a Hindu must give a feast irrespective of the price of the victuals. The force of conventions and customs is very great. The demand for necessities for efficiency is not always and everywhere equally inelastic. Where standard of living is high they become as insistent as necessities for existence or conventional necessities; but if the standard of living is low, they lose their pressure and are allowed to go unsatisfied.

Articles of comforts and luxuries are not absolutely indispensable so that their consumption is drast-

ically curtailed if prices rise. Their consumption is capable of enormous extension as well. As such, if their price rises, people begin to demand them in less than proportionate quantities; and if their price goes down, their demand increases more than proportionately.

(2) *Influence of Variety of Uses*—Generally speaking, those things have the most elastic demand which are capable of being put to many different uses. For, if their prices rise, they can be withdrawn from some uses; and if they fall, they may be devoted to other new uses. For instance, if water, during a drought, is supplied at a very high rate by meter, people may apply it economically and scantily for bathing and washing purposes. But if it is supplied at a fixed annual charge, its use for every purpose is likely to be carried to the full satiety limit.

(3) *The Effect of Substitutes*—The demand for a commodity, which has many substitutes, is more elastic than the demand for a commodity which has no substitutes. For, in the former case, if one of the commodities becomes cheaper than the others, the latter will lose some of their consumers in favour of the former. The expansion of demand for the cheaper commodity will be correspondingly greater than if its only source of increased demand had been enhanced consumption of the original buyers.¹⁰ Thus coffee is a substitute for tea. If the price of coffee rises appreciably, people may take to tea. Demand for coffee will fall substantially and that for tea, rise likewise. However, if no substitutes are available, as is the case with salt, the demand will not fall considerably as a result of a rise in price.

(4) *Influence of Sensibility and Acquired Tastes and Distastes*—The demand for things also depends upon sensibility: some people care little for refined flavour in their tea provided they can get it as much as they like; while others crave for a high quality but are easily satiated. Constant use also gives rise to acquired tastes and distastes. A man who has

10. See Scott, *The Approach to Economics* p. 29

become used to writing on fine, glazed paper will continue to demand it irrespective of a rise in its price. Similarly, a man, who does not like coffee, will not demand it howsoever low its price may go.

(5) *Influence of Price*—Elasticity of demand is small at very high and very low prices; it is great at medium prices. If the price of a commodity is very high, an ordinary rise or fall in price will not affect the demand for it because then it is bought by the rich alone who will buy it at any price. If the price is very low, everyone can buy who wishes to buy and an additional fall in price does not make any difference in the amount demanded. But at medium price, it is consumed by the rich and the upper middle class people; so that if the price rises a little, the latter will give up its consumption and the demand will shrink. On the other hand, if the price falls a little, lower middle class people, and even the poor, might begin to consume it and the demand may rise. Hence the elasticity is great at medium prices.

The Case of One Class of Society—The above statement refers to the demand of the society as a whole. If we consider the demand of a class of people only, we will find that "the elasticity of demand is great for high prices and great, or at least considerable, for medium prices; but it declines as the price falls, and gradually fades away if the fall goes so far that satiety level is reached."¹¹ When the price of a thing is very high relatively to any class, any considerable fall in its price causes a great increase in the demand for it. When the price drops to the middle level, those members of the class who occupy lower financial position begin to make some demand while the old consumers slightly increase their demand. The demand rises though not very briskly. But as the price falls, the demand increases only half-heartedly since most of it has already been satisfied. At the satiety level of the class, demand becomes thoroughly inelastic.

(6) Finally, the demand is generally more elastic for commodities which take up a larger propor-

11. Marshall, *Principles of Economics*, p. 103.

tion of one's income than for those which only take up a smaller/one, simply because one hardly thinks about the very small items. The demand for salt is very inelastic partly because there is no substitute for it but also because so little is spent on it. Similarly, the demand for sewing cotton is inelastic because the cost of sewing cotton is so small a part of the cost of making clothes that nobody worries much about it.¹²

§ 3. SUPPLY

Meaning of Supply

Supply is the quantity of a commodity that a seller offers for sale at a certain price. We cannot think of supply apart from price. Just as we distinguished between desire and demand, so we must also distinguish between stock and supply. The stock is the quantity of goods that *could* be sold; the supply is the quantity that *would* be sold at a given price.¹³ If in a market at a particular day and at a particular time 2,000 maunds of wheat are offered for sale at Rs. 4 per maund, then 2,000 maunds is the supply of wheat at that price. But there might be a stock of 10,000 maunds of wheat at that time, out of which only 2,000 maunds are being offered for sale.¹⁴

Supply Price

By supply price is meant the price at which a certain quantity of a commodity is offered for sale by its suppliers or sellers.¹⁵

12. See Scott, *op.cit.*, p. 30

13. Pearson, *The Economics of Everyday Life*, Part I, p. 110

14. Supply, according to Dibblee, is a group of sacrifices made by producers in manufacturing articles of the same kind. It is usually and conveniently measured in quantities and prices. Similarly, demand is a group of values of the same kind. But he maintains that demand cannot be definitely measured and must be considered as an indeterminate aggregate, because it cannot be definitely said how many values will come within the operating field of a market. See Dibblee *The Laws of Supply and Demand*, pp. 38-39 pp. 18-19

15. Supply is based on the unwillingness of men to undergo certain discommodities which are necessary for production, namely, to labour or to sacrifice themselves. A certain price must be offered to induce men to make these efforts or sacrifices. The amount produced depends on the price offered It is called Supply Price—John A Todd, *Political Economy for Egyptian Students*, p. 35.

The Law of Supply

Supply varies with a change in price. It increases with a rise in price and decreases with a fall in it. Thus both supply and price move together. This is known as the *Law of Supply*.

The reason for the operation of the law is that if price increases, even those inefficient producers whose cost of production is high, find it profitable to put their produce on the market. And as the price goes on increasing, the output offered for sale keeps pace with it. On the other hand, if the price decreases, some producers whose cost of production is greater than the price, withhold their supply from the market and, therefore, the supply decreases. The following diagram compares the laws of demand and supply : demand and price move inversely, while supply and price move together.

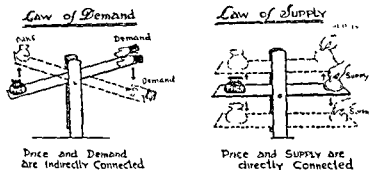


Figure Comparing the Laws of Demand and Supply

Supply Schedule

A Supply Schedule is a list or a record showing the relationship between various prices and the supply of a particular commodity in a particular market on a particular day and at a particular time. The following is the supply schedule of a grain dealer for wheat in Mutthigunj (Allahabad) on the 1st June, 1940 at 10 A. M. :—

PRICE Rs.	SUPPLY Mds.
6	10,000
5	9,000
4	8,000
3	6,500
2	4,000
1	1,600

Supply Curve

The supply schedule can be represented

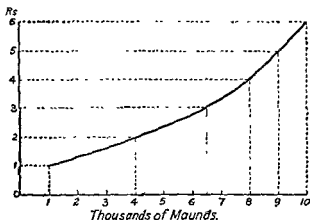


Figure Showing the Supply Curve.

diagrammatically. The curve thus obtained is called the supply curve. The above supply curve is the diagrammatic representation of the supply schedule of grain given on the top of this page.

CHAPTER IV

THEORY OF VALUE

A man is likely to be a better economist if he trusts to his common sense and practical instincts, than if he professes to study the theory of value and is resolved to find it easy—*Marshall*.

A very important part of Economics is the study of the way in which value, or price, is determined; in other words, how the demand and supply balance. The Theory of Value (or price¹) is the pivot on which the Science of Economics is based. Economics studies human activities in relation to wealth, and wealth consists of those articles which possess value; so the theory of value is of prime importance to economists.

§ 1 THE THEORY OF VALUE

The Theory of Value seeks to explain the following things :—

1. Why the purchaser pays a price for an article?
2. Why the seller demands a price for his commodity?
3. How price is determined?

We shall deal with each of these points one by one.

Why Price is Paid ?

A person is prepared to pay a price for a commodity because it satisfies his want or wants. And the more intense is the want that it satisfies, the higher is the price he is prepared to pay for it. If you are extremely hungry, you may offer Rs. 10 or even Rs. 100 for a loaf of bread rather than go without it. But after your hunger is appeased and the intensity of your present want reduced to minimum, you may not pay for it anything more than, say, 2 as. It follows, therefore, that the price that a person is willing to pay for the first unit of a commodity is considerable

1. Value expressed in terms of money is called price.

because it satisfies his want at its most intense stage. For every successive unit the amount that he is prepared to pay, goes on diminishing. And if he continues his purchases, a point will, sooner or later, come when the money that he has to pay for a unit of a commodity is equal to its utility to him. Obviously, no discrimination can be made, for all practical purposes, between the first and the final (or marginal) unit and the price paid for the former will be the same as that paid for the latter. In other words, the price per unit that a buyer is willing to pay is equal to the marginal utility. It is the maximum price that he can pay : he may pay less, but not more, than that.

Why Price is Charged ?

A seller charges a price for a commodity because he incurs certain expenses in producing or acquiring it. He will not obviously sell the commodity at a price less than the expenses of production. It is the minimum price he will accept : he may charge nothing in addition to it, but he will not be satisfied with anything less than that.

Fixation of Price

Buyer's maximum, then, is determined by the marginal utility : he will not pay more than this. Similarly, seller's minimum is determined by the expenses of production : he will not accept less than this. The actual price is fixed somewhere in between these two limits by the *relative influence of demand and supply*. The price at which demand equals supply is the price at which business is done. In other words, price is determined by the equilibrium of the forces of demand and supply.

Expenses and Cost of Production

In the present discussion, we shall have to make frequent use of the terms cost and expenses of production. It is, therefore, necessary to distinguish between these two terms.

Production involves efforts and sacrifices. The efforts and sacrifices involved in producing a commodity constitute its *Real Cost or Cost of Production*.

Marshall says, "The exertion of all the different kinds of labour that are directly or indirectly involved in making it, together with the abstinence or rather the waiting required for saving the capital used in making it—all these efforts and sacrifices together will be called the real cost of production of the commodity."²

Efforts and sacrifices, however, cannot be easily measured in themselves. But they can be measured in terms of money for which they are purchased. The amount of money spent in producing a commodity is called its *Money Cost of Production* or *Cost Price* or *Expenses of Production*. In the words of Marshall, "the sums of money that have to be paid for these efforts and sacrifices will be called either its money cost of production, or for shortness, its expenses of production; they are the prices which have to be paid in order to call forth an adequate supply of the efforts and waitings that are required for making it, or, in other words, they are its supply price."³

Time Element in the Theory of Value

Time element is of profound significance in the theory of value and modifies the application of the theory to the actual conditions. The theory of value, as dealt with above, is very general, its application varies according to the time involved in the determination of the price. Two specific cases are distinguishable: (1) Value or price as determined in short period, called *Short Period or Market Price*; and (2) Value or price as determined in long period, called *Long Period or Normal Price*. We shall discuss them in the following sections.

2. Marshall, *Principles of Economics*, pp. 338-339

3. *Ibid.*, page 339. In many text-books, cost of production and expenses of production are often used as synonyms. Marshall let fall a hint of caution on this point. Mill and some other economists, he says, have followed the practice of ordinary life in using the term, "cost of production in two senses, sometimes to signify the difficulty of producing a thing, and sometimes to express the outlay of money that has to be incurred in order to induce people to overcome this difficulty and produce it. But by passing from one use of the term to the other without giving explicit warning, they have led to many misunderstandings and much barren controversy." Marshall, *Economics of Industry*, p. 195 n.

§ 2. THE MARKET PRICE OR THE TEMPORARY EQUILIBRIUM OF DEMAND AND SUPPLY

First, we shall describe how the price of a commodity is determined in the market, in short period. The price prevailing in the market in short period, say, at any particular moment or day or week, is known as *Market or Short Period Price* and is the object of our discussion.

We take the example of a wheat market. Let us assume, for the sake of simplicity, that all the wheat in the market is of the same quality. The quantity which each seller would be willing to sell at any particular price will depend upon his own need for money and by his estimate of the future and present conditions of the wheat markets. There are some prices which no seller would accept; some, which no one would refuse. There are other intermediate prices which will be acceptable to some and not to others. At some price some would offer a particular quantity for sale but may offer more if price goes up. Let us suppose that when the price of wheat is Rs. 2 per maund, 500 maunds are offered for sale. If price rises to Rs. 2-8-0 per maund, another 200 maunds will be offered, while the holders of another 200 maunds would be tempted to sell only at Rs. 3 per maund.

Again, let us suppose that if the price is Rs. 3 per maund, only 600 maunds would be purchased; if Rs. 2-8-0 per maunds, another 100 maunds will be purchased; and that at Rs. 2 per maund yet another 250 maunds.

These facts may be put in a table in the following way :—

At the price	Holders will be willing to sell	Buyers will be willing to sell
Rs. as. p	Maunds	Maunds
3 0 0	900	600
2 8 0	700	700
2 0 0	500	950

Now, suppose the price at any particular time is below Rs. 2-8-0 per maund. At this price even those sellers who would sell at that price rather than leave the market would argue that at that price, the demand would be more than the supply; so they will wait and by waiting help to bring the price up.

If the price rises above Rs. 2-8-0 per maund, buyers will argue that the supply will be much greater than the demand at that price; therefore, even those of them who would rather pay that price than go unserved, wait; and by waiting help to bring the price down.

So the price will be tossed hither and thither like a shuttle-cock, as one side or the other gets the better in the "higgling and bargaining" of the market. But ultimately business will be done at Rs. 2-8-0 per maund, at which price the demand and supply are equal; for, as we have seen, business can not be done either at a higher or a lower price than that.

In order to represent the above figures graphically, let us take OX for representing quantity of the

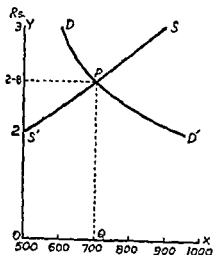


Figure Showing the Fixation of Price.

commodity and OY for price. By plotting the points with the help of the given figures, demand curve DD'

is drawn and the supply curve SS' is constructed. They cut at P . Therefore, P is the Price at which transactions take place. At PQ price, OQ quantity of the commodity can be sold.

We conclude, therefore, that "in any market at any time the price will be so adjusted, through the competition of buyers and sellers, that the quantity demanded will be equal to the quantity offered at that price."⁴ This is called the "temporary equilibrium price" (Marshall) or the "equation" price (Mill).

The Relative Strength of Demand and Supply in Determining Market Price

Price, as we know, is determined by the relative strength of demand and supply somewhere between the marginal utility and expenses of production. But the question is which of these two forces exerts a greater decisive influence in the determination of price in short period?

In short period the supply is fixed. For instance, on a particular day at a particular time the supply of fish in the fish market is fixed, and cannot change in response to a change in price. But there is no such fixity with regard to the demand for fish: demand may increase or decrease. In the determination of the market price, the supply is a fixed and given factor; it is the variations in demand which determine price. If demand rises, price shoots up; if the former decreases, the latter sinks.

§ 3. NORMAL PRICE OR EQUILIBRIUM OF NORMAL DEMAND AND SUPPLY

Normal Price

The market price of a commodity may vary from day to day and from time to time, but if we analyse such market fluctuations over a fairly long period, we will find a more or less constant price above and below which the market price tends to fluctuate. The price level to which the market price tends to return repeatedly is the price prevailing in the long

4. Nicholson, *Elements of Political Economy*, p. 225.

period and is called *Long Period or Normal Price*⁵. As the normal price approximates cost price, it is also sometimes defined as the price which corresponds with the cost of production.

Illustration—The monthly prices of bananas in the year 1939 are given below :

	Per dozen (as.)
January	2
February	3
March	4
April	3
May	2
June	3
July	4
August	5
September	2
October	3
November	3
December	2

These are the market prices prevailing in various months.* The variations in prices are brisk. But if you take an average of these prices, you will get at $(2+3+4+3+2+3+4+5+2+3+3+2=36/12=)$ 3as. All these prices fluctuate above and below 3as. Three annas per dozen, then, is the Long Period or Normal Price⁶.

5. "Market prices, that is, the prices at which goods are actually sold from day to day, are variable and irregular in their operation But behind most market prices are *Normal Prices*, which are much less subject to changes. This is because the conditions of production are more stable than the market conditions under which goods are bought and sold, and serve constantly to recall prices from the more or less violent fluctuations of the market."—Seager *Principles of Economics*, p. 120.

*It has been assumed that the same price rules throughout the month: or, that these are the monthly averages.

6. Also see Moreland, *An Introduction to Economics*, pp. 208-9.

Determination of Normal Price

The normal price of a commodity is determined by the forces of demand and supply, as is the case in the short period. But here *the expenses of production play the decisive role*. For, if the normal price remains above its expenses of production, profits will accrue; consequently, production will increase, new producers will be attracted to the industry while old producers will be impelled to increase their volume of production. The supply having thus increased, the price will fall down. On the other hand, if the normal price is lower than the expenses of production, reverse conditions will occur: losses will begin to appear and production will be curtailed—some producers will withdraw and others will work for shorter period. These conditions will result in the reduction of the supply and so cause price to rise again. Thus for a given output, normal price must be equal to the expenses of production in the long period⁷. It is apparent, therefore, that in this case (normal) price tends to approximate the expenses of production.

Article Having No or Little Cost of Production

The statement that 'the value of a commodity is normally equal to its cost of production' sometimes misleads students to suppose that 'it is the cost of production of a commodity which gives it its value, so that if there were no cost of production, there would be no value.' Cost of production, it should be borne in mind, represents only the supply side of the equation of exchange, and does not concern itself with its demand side. But price is determined both by demand and supply. As such, the above statement is not quite correct.

An article may have little or no cost of production but may be extremely valuable. Suppose you see a diamond lying in a desert you are crossing. You lift it up. Its value is immense though its cost of

7. The expenses of production of different firms differ. It may be asked, therefore, which is the firm whose cost of production, we are referring to above? It is the average or the "representative firm." See Marshall, *Principles of Economics*, pages 342-343.

production is negligible—you had simply to bend yourself and pick it up. Why? Because the demand for diamonds is far greater than their supply.

Again, an article may have high cost of production but little value. If somebody takes into his head to construct a house in a desert, it will be a very costly project, indeed. But since few will like to live in the midst of a desert, its value will be very little. Its cost is great but the demand for it is so small that its value is very low.

Price, it should be remembered, is the function of both the demand and the supply.

Market and Normal Price

The difference between market price and normal price is probably clear by this time. Market price is the price ruling at any particular time, normal price is the price which rules in the long period. Normal price equals cost price; market price *tends* to be equal to the normal price and, therefore, cost price. Normal price is an average of the various market prices prevailing in the period considered to be long.

§ 4. RELATIONSHIP BETWEEN MARKET PRICE, NORMAL PRICE AND COST PRICE

From the above discussion it is plain that there is a very close relationship between market price, cost price and normal price. Normal price is equal to the *cost price or money cost of production*. And market price fluctuates round normal price: it may vary from time to time but it cannot remain far away from the normal price for any considerable period. If it remains higher than normal price for long, unusual profits will begin to appear, production will increase in consequence, and, demand remaining the same, the market price will tend to fall. This movement will stop only when the market price comes close to the normal price and unusual profits cease to occur. Similar reasoning will show that the market price cannot remain below normal price for long. For, if this happens, unusual losses will begin to appear, production will shrink in consequence, and demand

remaining the same, market price will tend to rise. This upward movement will stop only when the market price comes close to the normal price and unusual losses cease to occur. Thus the market price cannot diverge violently from the normal price for long; it simply fluctuates just above and below the normal price and shortly returns towards it.

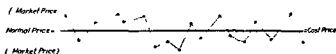


Figure showing the relationship between market price, normal price and cost price

Normal price, then, equals cost price; and market price fluctuates around the normal or cost price, always showing tendency to kiss the latter. The above diagram illustrates this point fairly well.

§ 5. INFLUENCE OF UTILITY AND COST OF PRODUCTION ON PRICE

It is sometimes controverted whether money cost of production or utility governs price. As a matter of fact, both determine price, in the short and long periods alike. In the short period, however, supply is fixed and demand varies, therefore, demand (or marginal utility) exerts a more significant influence. In short period, then, the price is determined by *demand* in relation to supply, or marginal utility in relation to expenses of production. In the long period, expenses of *production* are of supreme importance, as shown above; and demand or marginal utility is eclipsed by its influence. Hence normal price is determined by expenses of production in relation to utility.

In connection with this controversy, Marshall very aptly observes: We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost of production. It is true that when one blade is held still, and the cutting is

effected by moving the other, we may say with careless brevity that the cutting is done by the second; but the statement is not strictly accurate. In the same way, in short period, if a person chooses to take the stock for granted and say that the price is governed by demand, his brevity may perhaps be excused so long as he does not claim strict accuracy. In the long period, similarly, if a person takes it for granted that there will any how be enough demand for the commodity, he may be excused for ignoring the influence of demand, and speaking of (normal) price as governed by cost of production—provided only he does not claim scientific accuracy. Thus we may conclude that, *as a general rule*, the shorter the period which we are considering, the greater must be the share of our attention which is given to the influence of demand on value; and the longer the period, the more important will be the influence of cost of production on value.⁸

⁸ Marshall, *Principles of Economics*, pp. 348, 350.

CHAPTER V

MONEY

Money is the centre around which economic science clusters—*Marshall*.

After discussing the Theory of Value, which is the essence of Exchange, we now pass on to the discussion of the Exchange Mechanism. Let us first take up the study of *Money*

§ 1. MONEY.

Origin and History of Money

Barter, we learnt in the preceding chapter, has three shortcomings, namely, the improbability of coincidence between persons wanting and persons possessing; the complexity of exchanges, which are not made in terms of one single substance; and the need of some means of dividing and distributing valuable articles¹. To remove these defects, men, at a very early stage, fixed upon some *intermediate commodity* which began to be universally accepted in exchange for goods and services, which formed a basis for the measurement and comparison of the value of other commodities and in which shape value could be subdivided. This, they called Money.

The actual form assumed by money since its origin, has been extremely variable. Living as we now do in civilized communities and accustomed as we are to the use of metallic coins and paper notes, we popularly pick up the habit of identifying money with them. But in early times money existed in different forms². In the hunting stage, furs and skins were employed as money. In the pastoral stage, the next higher stage of civilization, they were replaced by sheep and cattle. A passion for personal decoration being one of the most primitive and powerful instincts of the human race, ornaments

1. W. S. Jevons, *Money and the Mechanism of Exchange*, p. 13.

2. See Ridgeway, *The Origin of Metallic Currency and Weight Standards*; Powers, *The Tribes of California*, Powell, *Handicrafts in a Wild Country*, etc.

also began to be circulated as money. In the agricultural stage, corn, "kowries", etc., were used for the purpose. Later on, articles like cotton cloth, salt, etc., were tried. All of them were, however, found wanting in some respect or the other, and were finally replaced by gold and silver. The latest form of money is the paper money, which is decidedly its most convenient and the most economical type.

Definition of Money

Different writers have defined 'money' (or 'currency'³) in different ways. It is defined sometimes narrowly and at others broadly. In the narrow sense, money refers to metallic coins only. In the broad sense, money signifies each and every form of the medium of exchange—metallic coins, currency notes, cheques and bills of exchange. Modern economists, however, steer the mid-way and define money as a *commodity which is generally acceptable in final payment of dues*. Ely defines money as "anything that passes freely from hand to hand as a medium of exchange and is generally received in final discharge of debts."⁴

The following diagram illustrates the meaning of the term money. The smallest circle represents money in the narrow sense, the bigger circle, in the

3. Money and currency are interchangeable terms. All the things current as money constitute 'Currency'.

4. Robertson defines money as a commodity which is used to denote anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligation. Robertson, *Money*. J. M. Keynes says, "Money is that by the delivery of which debt contracts and price contracts are discharged and in the shape of which general purchasing power is held"—J. M. Keynes, *Treatise on Money*, Volume I.

proper sense and the biggest circle, in the broad sense.

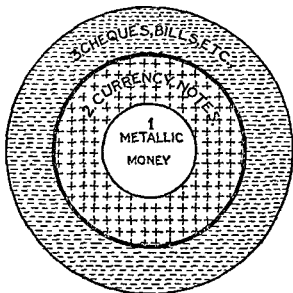


Figure illustrating the scope of the term "Money." 5

According to this definition, *cheques* are not money. They are not legal tender and may not be accepted from persons little known or of little credit. As such, they do not pass freely from hand to hand and are not money. The same is true of *Hundies*. *Currency Notes*, on the other hand, are legal tender and are usually issued by authority of unimpeachable soundness. Consequently, they are freely acceptable and are money. *Pice* or *one-anna pieces* are legal tender to the extent of Re. 1 only. They are not acceptable freely after that limit partly because they lose their legal tender character and partly because they become inconvenient; and consequently cease to be money after that point.

5. Students may remember the following:—

In narrow sense, Money = Metallic Money.

In wide sense, Money = Metallic money + Paper Money + Bills of Exchange, cheques etc.

In proper sense, Money = Metallic Money + Paper Money.

Functions of Money

Money performs four main functions⁶ which are as follows :—

(1) *Common Medium of Exchange*—The fundamental function of money is to act as a common medium of exchange. The significance of the word 'medium' is that it becomes an intermediate thing in the commerce between the producers and consumers of any and every article⁷. Goods, instead of being exchanged directly for other goods as under barter economy, are bought with, and sold for, money. Money thus becomes a universal tool for making exchanges. It is freely acceptable in exchange for all other commodities; and its owner is able to get for it anything he likes without any inconvenience. This is the primary function of money, other functions having been derived from it. It is essentially the *Money Function*. Whatever performs this function, does this work, is money⁸. This function does away with the necessity of the double coincidence of wants which has to be faced under the barter system.

(2) *A Common Measure of Value*—The first function of money has for its natural corollary the second function, namely, to act as a common measure of value. When persons become used to exchange things for one particular commodity (money), they measure the values of all the articles in the terms of the latter alone, so that all exchanges are most readily calculated and adjusted by a comparison of the money values of the things exchanged. Money, thus, becomes a common measure of value.

(3) *Store of Value*—The third function of money is to enable its owner to preserve value in this shape for a long period, without any fear of loss⁹. Metallic money wears out very slowly and is an ideal

6. Money is a matter of functions four.

A medium, a measure, a standard, a store,

7. Walker, *Political Economy*, p. 122

8. Walker, *op. cit.*, p. 123

9. When we speak of value being stored in money, we do not imply that value is something intrinsic in money; we mean that money is a durable thing and that it is always saleable—Turner, *Introduction to Economics*, p. 202.

store of value. Paper notes do not fulfil this function very well.

The storing of value in the form of goods is not as convenient as in that of money mainly because goods deteriorate through passage of time; and their value fluctuates widely. Moreover, they occupy much space. Such difficulties do not arise in the case of money. If the owner of money were to suffer loss by not exchanging it at once, much of its usefulness will, indeed, be lost.

(4) *A Standard of Deferred Payments*—In the industrial society of to-day, loans are daily given and taken and the repayment is deferred or postponed to a future date. In such cases, it is only just that the borrower should return to the lender the same value which he had borrowed. This is possible if lendings and borrowings are carried on in terms of money, whose value remains fairly stable; and not in terms of other goods or services, whose value is subject to wide and frequent fluctuations. Money thus becomes the measure by which the value of future payments is regulated.

Attributes of a Good Money Commodity

The commodity of which money is made has to be carefully selected so that money may fulfil its functions fairly well. An ideal money material should possess the following qualities¹⁰ :—

(1) *Utility or General Acceptability*—General acceptability is the very essence of money. Unless a person knows that the money which he accepts in exchange for his goods or services, will be taken without any objection by others as well, he will not accept it i.e., it will cease to be current. A commodity can possess general acceptability if it has some intrinsic utility independent of its value for monetary purposes. Gold and silver are generally acceptable by all without

10. The chief qualities are Cognisability, Utility, Portability, Durability, Indestructibility, Stability, Homogeneity. The first letters of these terms make "CUP, DISH". By this formula, these attributes can be easily remembered. Malleability is another quality, which may be added in the end as the eighth attribute.

any hesitation because they are used for ornamental purposes¹¹.

(2) *Portability*—A commodity fit to be used as money must be such that it can be easily and cheaply transported from one place to the other. In other words, it must possess high value in small bulk. Precious metals possess this quality. In the case of oxen and grain, a small value occupies a large bulk and weight; hence they are unsuited as money commodity.

(3) *Indestructibility or Durability*—As money is to be passed about in trade and kept in reserve, it must not be subject to easy deterioration, either in itself or as a result of wear and tear. "It must not evaporate like alcohol, nor putrefy like animal substances, nor decay like wood, nor rust like iron. Destructible articles, such as eggs, dried cod fish, cattle, or oil, have certainly been used as currency; but what is treated as money one day must soon afterwards be eaten up¹²" Gold coins are very lasting: they take about 8,000 years to wear out completely. Silver coins are not equally lasting but wear out fairly slowly. As such gold and silver are considered to be excellent money commodities.

(4) *Homogeneity*—All portions or specimens of the substance used as money should be homogeneous, that is, of the same quality, so that equal weights have exactly the same value. In order that a commodity may be used as a measure of value, it is essential that its units are similar in all respects. Gold and silver are of the same quality throughout; their various parts are similar in chemical and physical constitutions and their consistency is the same throughout the mass.

11. Some students may think that paper, of which paper note is made, does not possess any utility independent of its value as money; hence, it should be generally acceptable. But in actual practice it is not exactly so. It must be remembered by them that certain cash or gold resources or securities always back the notes; so that the note is made of not only paper, but also of the resources backing it.

12. W. S. Jevons, *op. cit.*, pp. 36-37

(5) *Divisibility*—The money material should be capable of division; and the aggregate value of the mass after division should be almost exactly the same as before. If we use diamond as money and perchance it drops from our hand and breaks, we will suffer enormous loss. This is not the case with precious metals. Their portions can be melted and remelted together any number of times without much loss.

(6) *Malleability*—The money material should be capable of being melted, beaten and given convenient shapes. It should neither be too hard nor too soft. If the former, it cannot be easily coined; if the latter, it would not last long.

(7) *Cogniscibility*—By it we mean the capability of a substance for being easily recognised and distinguished from all other substances. As a medium of exchange, money has to be continually handed about and it will cause great inconvenience if every person receiving money were to scrutinize, weigh and test it. It should have certain distinct marks which nobody can mistake. Gold and silver are at once recognized by their distinctive colour, metallic ring and heavy weight for small bulk, and, as such, satisfy this condition admirably.

(8) *Stability of Value*—Money should not be subject to fluctuations in value. Fluctuating standard of value is just like a changing yard or seer. The value of a material which is used to measure the value of other material, must be stable.

People employ money as a standard of value for long period contracts; and they often pay as much money as they had borrowed after some time. Hence a change in the value of money over a long period inflicts injury on some sections of society. Fluctuations in the value of money at any particular time are also injurious. If a labourer who has earned eight annas today to be spent to-morrow, finds in the mean time its value (that is, purchasing power) reduced by half, he would be seriously injured.

The value of gold remains more or less stable as its yearly output is small compared with the great quantity already in existence. The value of silver, however, is not so stable.

Classification of Money

(A) *Metallic and Paper Money*—Money may be classified into two simple classes: (1) The money printed on, or made of, some metal, called metallic money. It has an intrinsic value, i.e., some value independent of its monetary value; and (2) The money printed on a piece of paper, called paper money, e.g., the Reserve Bank note. It has no intrinsic value other than its value as a monetary unit¹³.

(B) *Limited and Unlimited Legal Tender*—Money is always legal tender but the extent to which it is legal tender differs. The degree of its legal tender character is another standpoint of its classification.

By legal tender is denoted the money which a creditor is, by law, bound to accept in discharge of debts. A refusal on the part of the creditor to accept it as such, amounts to a legal offence punishable by law. According to our definition of money, a commodity called money must be *generally acceptable*. This can happen only if it is legal tender. Hence money is always legal tender; and anything which is legal tender is money. A commodity which is not legal tender cannot be regarded as money.

Money may be *limited* legal tender or *unlimited* legal tender. The unlimited legal tender is the money which can be legally tendered or given by the debtor to his creditor to any extent whatsoever. In India *rupees and eight-anna bits* are unlimited legal tender; so also are the Reserve Bank notes. Limited legal tender, on the other hand, is the money which is tenderable only up to a limited extent. In our country two-anna and one-anna pieces and the pice are limited legal tender.

13. Unless we regard the Reserve behind it as representing its intrinsic worth.

Importance of Money

Money has always been held in high esteem and the influence of pecuniary calculus upon ethical standards has been very definite. As Horrace wrote—

All things human and divine, renown,
Honour and worth, at money's shrine go down,

Pope similarly writes—

There London's voice, get money, money still,
And then let virtue follow if she will,

Prof. Davenport gives the following impressive description of the social importance of money: More and more human effort, human interests and desires and ambitions fall under the common denomination of money. Health is easier for him who has the wherewithal to pay for goods, foods and medicines, to travel and employ good nursing and to command capable physicians and efficient surgeons. And in their degree also, love and pity and respect and place are bought and sold upon the market. All economic comparisons are made in money terms, not in terms of beauty or of artistic merit or of moral deserving.

The economic importance of money eclipses its social importance. A chemist has his delicate balance for measurement; the physicist has his finely graduated ruler; the economist similarly employs money as a rough measure. The whole economic science is based on money: economic motives and activities are measured by it.

While studying Consumption we had to take the help of money at every stage. We arranged the items of our expenditure in order of their utility which is measured with the measuring rod of money. The urgency of our wants, the satisfaction derived from the consumption of a commodity and such other motives are measured by money.

Production is greatly facilitated by the use of money. The modern large scale production is based on division of labour, which, in its turn, is the gift of the introduction of money.

Under Exchange, the importance of money shows itself most prominently. The old barter economy was characterised with serious shortcomings, to remove which men had to hit upon a universal "go-between" in exchange of commodities. Now-a-days almost all the transactions are carried on in terms of money.

Money plays an important role in the Distribution of wealth and income of a group of co-operative agents of production. The share of various agents is determined and paid in terms of money. The distribution of social energy amongst the various forms of enterprizes takes place through the medium of money. Whenever any business shows high money profits, people begin to invest money in it.

Indeed, in every phase of Economics, money makes its appearance with superb prominence. Economic science, Marshall aptly remarks, clusters round money.

§ 2. METALLIC MONEY

Coins

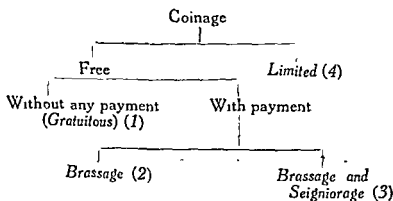
In modern times, metallic money takes the shape of coins. In primitive days, precious metals in their rude form were used for this purpose. The system was very inconvenient; money had to be weighed and assayed each time an exchange was effected. Hence, the system of shaped pieces of the metal, whose weight and fineness was certified by a mark or stamp, came into vogue. This form of money, however, was open to clipping, *i.e.*, cutting away of the small particles of the metals, and abrasion, *i.e.*, the practice of putting a larger number of coins into a bag and shaking it so as to remove small fragments of the metal. The next stage, therefore, was marked by the advent of the coin, *i.e.*, a piece of metal of a particular shape bearing a seal of a certain weight and fineness. After some time the edges of these coins began to be milled and impressed with a complex and artistic design so as to make counterfeiting difficult. Thus the modern coin came into being. Coins are defined by Jevons as *ingots of which*

Gratuitous Coinage, Brassage and Seigniorage

Free coinage does not necessarily mean that the state converts metal into coins free of any charge. It may or may not do so. When it does not make any such charge, the coinage is said to be *gratuitous*. Where the Government levies a charge for coinage just equal to the cost of minting the coins, the charge is called *mintage* or *brassage*. If the Government charges something over and above the cost of minting, the additional charge so made is called *Seigniorage*¹⁶.

Illustration—Suppose there is free coinage in any particular country. If you give one ounce of gold and get it converted into coins free of charge, the coinage is *gratuitous*. But if the cost of minting is 1 per cent and the minting charges have to be paid to this extent, then 1 per cent charge is the *brassage* or *mintage*. If the State charges 3 per cent in place of 1 per cent for minting, 2 per cent additional charge is *seigniorage*.

These three systems of coinage are to be found only in case of free coinage and not in case of limited coinage. The following diagram gives the consequential four systems of coinage :



16. When the Government makes a profit out of the coinage by fixing a low legal tender, the amount taken in addition to the cost of coinage is called *seigniorage*.—Penson, *op. cit.*, P. I. pp. 122-123.

Debasement

The reduction of the weight, or fineness, or both, of the metal contained in a coin is called debasement¹⁷. Debasement through the reduction in the fineness of metal can generally be practised only by the Government. Weight can be reduced by others as well. The following are the chief methods adopted for this purpose :—

(1) *Clipping*, i.e., the cutting away of small portions from the edges of the coins.

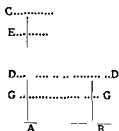
(2) *Sweating*, i.e., the reduction of the quantity of the metal in the coin by the action of corrosive chemicals.

(3) *Abrasion*, i.e., the practice of shaking up the coins in a bag and then by removing minute particles of the metal.

Standard and Token Coins

A *standard coin* is one whose face value is equal to its intrinsic value. It is the principal money of the realm and is unlimited legal tender subject to free

17. It has sometimes happened, as in Tudor times, that the sovereign has issued money containing less than the standard amount of precious metal. This difference between the standard and real value is called debasement. (See Diagram)



Let AC=Nominal value of the coin

BD=Legal amount of metal in the coin.

BG=Actual amount of metal in the coin

Then CE=Seigniorage.

ED=Seigniorage.

DG=Debasement.

(—Ibid. p. 123)

coinage. Since its face value and intrinsic value are the same, it is also called the '*full-bodied coin*'. A *token coin*, on the other hand, is the one whose face value is greater than its intrinsic value. It is the subsidiary money and is limited legal tender subject to limited coinage. Token coins are variously styled as the '*fiat coins or money*' since their value depends, not on their intrinsic worth, but on the order of the State.

Before September 1931, the gold sovereign in the United Kingdom was the standard coin of that country. But at present she has gone off gold, and paper-pound sterling has replaced the gold sovereign. In India, there is no standard coin in the strict sense of the term. Our principal coin is the rupee which is standard money in so far as it is the principal money of the realm and is unlimited legal tender, and also token money in as much as its face value is greater than its intrinsic value and it is subject to limited coinage. Because of its hybrid character, it has been well styled as the "*token standard*". Some economists, however, like to call it *the standard money of India* for "as long as the main currency is in rupees, all contracts are made and taxes calculated in rupees, and rupees are the legal tender to any amount, the rupee is really the standard".

§ 3. PAPER MONEY

In the modern State, we find considerable quantity of paper money circulating side by side with metallic money. The term paper money refers to Government or Bank notes which pass freely from hand to hand. Cheques and bills of exchange are not included under paper money.

The real nature of paper money was well expressed by Ricardo when he said that the whole charge for paper money may be considered as seigniorage. Though it has no intrinsic value, yet by limiting its quantity, its value in exchange is made as great as an equal denomination of coin, or of bullion in that coin. It is not necessary that paper money should be payable in metallic coins to secure its value; it is only

necessary that its quantity should be regulated according to the value of the metal which is declared to be the standard.

Advantages of Paper Money

Paper money is becoming increasingly more popular because of the many advantages that it possesses.—

(1) It is very light and handy and therefore, *can be easily and cheaply carried over long distances*. This advantage becomes marked when large sums have to be paid to somebody far far away.

(2) *It is very economical*. The cost of making it is very small. A sheet of paper and a printing press enables the Government to print money worth lacs and crores of rupees. Compare it with the great cost involved in digging the metal, transporting it to the mint and coining it, which the metallic money necessarily involves.

(3) It contains a very large value in a small volume.

(4) *In times of national emergency* and financial stringency, the Government need not find itself handicapped by lack of money material. It can set the printing press to work and print as much money as it likes.

Disadvantages of Paper Money

Paper money suffers from two main demerits:—

(1) The Government, if it so wishes, may go on printing notes to such an extent that their value goes down drastically. This, however, can be checked if the issue of paper is kept under the control of a Central or Reserve Bank independent of the undue Government influence.

(2) Because of its zero intrinsic value, its circulation is considerably restricted. This fear, however, has proved to be false. Even in a country like India where the majority of the people are ignorant and suspicious, paper money is quite popular and is used in the normal course of things. So long as the credit

of the issuing authority is unimpeachable and its word as good as gold, there need not be any such restriction to its circulation.

Convertible and Inconvertible Paper Money

Convertible Paper Money—Paper money may be convertible or inconvertible. It is convertible when it can be converted into standard metallic money of the land on demand. For instance, the Reserve Bank notes bear the promise to pay to the bearer on demand the sum of a certain number of rupees at any office of issue, a promise which is always fulfilled. The Reserve Bank notes are, as such, convertible.

In order to guarantee this convertibility, the issuing authority keeps a certain amount of bullion and metallic coins in "*reserve*." All the notes are not simultaneously presented for encashment. The issuing authority knows by experience the percentage of the total notes which are presented for the purpose. It keeps the same percentage of bullion and coins in reserve. The portion of the total notes issued, which is covered with this 'reserve' is known as *Covered Issue*, the rest being called *Uncovered or Fiduciary Issue*.

Inconvertible Paper Money—Inconvertible notes are not converted into standard metallic money by the issuing authority. Even then they may circulate by the sheer force of the authority of the Government. Hence, they are sometimes called *Fiat Money*.

If the quality of the inconvertible paper money does not exceed the legitimate business and industrial requirements there is no reason why they should not function efficiently. But, unfortunately, the issuing authorities begin to misuse their power and issue money in unlimited quantity, so much so that the notes become almost worthless papers. This happened in many European countries during the last Great War. For example, the value of the German Reichsmark deteriorated so much that it became less than the value of the paper on which it was printed ! The issue of inconvertible paper money is, therefore, a delicate affair.

CHAPTER VI

MONETARY STANDARDS AND VALUE OF MONEY

Jevons certainly and Edgeworth and Dr. Bowley probably, have also pursued something distinct from purchasing power of money, something which has to do with what they might describe as the value of money as such or as Cournot called it, the *intrinsic value of money*. This is will-o'-the-wisp, a circle squaring expedition which has given an elusive taint, difficult to touch or catch, to the treatment of the Theory of Price Index Numbers tradition in England *J H Keynes*

In the preceding chapter we discussed some elementary facts about money. Now we shall study problems of an advanced nature. They are—

- (1) Monetary Standards;
- (2) Value of Money; and
- (3) Gresham's Law

§ 1. MONETARY STANDARDS

Definition of a Monetary Standard

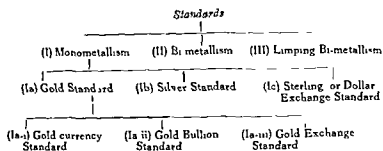
The way in which the currency system of a country is managed has vital effects on its economy. The currency system of a country should not be left to find its own level but should be controlled to fulfil certain objective or standard worthy of achievement. Such an objection is known as Monetary or Currency Standard. The Monetary Standard is also defined, with a slight variation as the standard of object which functions as the currency unit of a country or with reference to which the value of a currency unit is regulated. Thus when ox was as unit of currency, ox standard was prevalent¹.

In recent times a large number of standards has been devised and practised and sincere attempts have been made to achieve nicety, precision and efficiency in currency management.

1. B. R. Shenoy's article, *A classification of Currency Standards in the Indian Journal of Economics*, October, 1936, is instructive in this connexion.

Classification of Monetary Standard

We give below a simple classification of Monetary Standards :



This classification is not exhaustive,² but it serves our purpose quite well. We shall now describe this classification step by step.

I. Monometallism

A system of currency in which only one metal is used for the coinage of the standard or principal money is termed monometallism, and the country is said to be a monometallist country. The metals which have been used for this purpose are mainly two: gold and silver. Before September 1931, England used gold for this purpose and her currency standard was known as gold standard. During this month, however, England gave up the use of gold—she went off gold, as the phrase goes. China once used silver for the coinage of standard money; in other words, she had a silver standard. Now she has given it up. Indeed, there is a distinct trend in monetary field to abandon silver in favour of gold. But more of it presently.

II. Bi-metallism

Under bi-metallism two metals, usually gold and silver, are used for the coinage of standard money. Both gold and silver coins are unlimited

2. A more scientific and complete classification will be to put all these standards under the genus, *External Standards*. The following *Internal Standards* may, then be added to the table: Tabular Standard, Labour Standard, and Cost Price Equilibrium Standard. For a thorough classification, see B. R. Shenoy, *Op. Cit.*

legal tender and the mint is open to both the metals. Both are minted alike into coins of similar names and denominations. The coins of one metal are convertible into the coins of another metal at a fixed rate. The essentials of bi-metallism are: the existence of two kinds of standard money of two different metals; the opening of the mint for both of them; the recognition of both of them as unlimited legal tender; and the inter-convertibility of both of them at a fixed rate. There was a time when bi-metallism was put into practice in various countries of the world, but it was abandoned after a short period as fixed ratio between the value of the two coins could not be maintained. If the supply of silver increased considerably, it became cheaper in term of gold; one gold coin began to command more than the fixed number of silver coins. If the quantity of gold, on the other hand, increased appreciably, which was a rare occurrence, opposite results followed. On such occasions, Gresham's Law³ operated and bad money tended to drive good money out of circulation⁴.

This system was adopted by France in 1803 with the express purpose of preventing the country from a shortage of money in case the supply of one metal was drastically curtailed. What happened in actual practice was that the metal whose supply was increasing considerably and which was, therefore, cheaper of the two, alone remained in circulation; so that practically there was monometallism at any particular time. Thus for about fifty years, France

3. See Section 3 below.

4. The chief arguments of the bi-metallists are: (a) That the joint production of both metals would not vary so much as that of either of them. (b) that the dual system would tend to steady prices, and (c) that the supply of gold is insufficient for the currency requirements of all the countries of the world if universal monometallism were adopted. These arguments have not outweighed the following proved disadvantages of the bi-metallic system (a) the great difficulty of maintaining the mint ratio between the metals in face of constant fluctuations in the market ratio; and (b) the operation of Gresham's Law in driving from circulation the undervalued metal as soon as the market prices diverge from the mint ratio, resulting in an alternating coinage of gold and silver

had a silver standard and for twenty-seven years, gold standard. France abandoned bi-metallism in 1870.

III. The Limping Standard

The limping standard, or the limping bi-metallism, is a partial form of bi-metallism. Under the limping standard two metals, usually gold and silver, are unlimited legal tender but only one of them, invariably gold, is open to free coinage. This system existed in the United States of America and France before the Great War of 1914-18.

1-a. Gold Standard

If the reader refers to the table given on page 65, he will find that three main classes of monetary standards have been discussed by us. Now, we take up the sub-classes of mono-metallism. The gold standard comes first.

The gold standard is a monometallic standard in which only gold coins are declared to be the standard coins, open to free coinage and being unlimited legal tender. Whether gold coins are in actual circulation or not, is not a material point. The currency notes are convertible into some declared form of gold. The gold standard is based on the implication that the value of the monetary unit shall be kept equal to the value of a given quantity of gold⁵. This is done by unlimited purchase and sale of gold at a fixed price.

The gold standard is of three types: gold currency standard, gold bullion standard and gold exchange standard.⁶

(1a-i) *Gold Currency Standard*—Under the gold currency standard, the gold coins are put into actual circulation. Currency notes are convertible into these

5. A gold standard denotes a state of affairs in which a country keeps the value of its monetary unit and the value of a defined weight of gold at an equality with one another—Robertson, *Money*, Chapter IV, Section 1.

6. In discussing the gold standard and its off-shoots, much material of the *Pure and Applied Economics in India* by Amar Narain Agarwala (*Mysore Economic Journal*, Volume 24, No. 11, 1938) has been incorporated herein.

gold coins. It was essentially a pre-War reality when people believed that the existence of gold coins in circulation was an indispensable characteristic of gold standard. This idea has now been abandoned.

The technique of this standard is that the content of the gold coin is fixed by law, and by the device of free coinage, the values of the coin and the fixed amount of gold are kept at a parity. If at any time the value of coins in terms of gold goes up, or, what comes to the same thing, the value of gold in terms of coins goes down, people bring gold for coinage till the original parity is restored. On the other hand, if the value of coins in terms of gold goes down, or, what comes to the same thing, the value of gold in terms of coin increases, people begin to melt gold coins till the original parity is restored.

(Ia-ii) *Gold Bullion Standard*—Gold currency standard is an expensive standard since it requires the digging out of gold and its coinage. A more economical type of gold standard was, therefore, devised by monetary experts, which guaranteed the convertibility of currency notes into gold bullion, rather than gold coins, at a fixed rate. The gold currency, thus, disappeared and the national resources involved in coining the yellow metal were saved.

Under this standard the monetary authority is always prepared, on the one hand, to convert at least one important kind of money into uncoined gold at a fixed rate, and, on the other hand, to buy coined gold or money at a fixed rate.

(Ia-iii) *Gold Exchange Standard*—Gold bullion standard is an improvement over gold currency standard, inasmuch as it avoids the trouble and expense of coinage but labour has still to be spent in digging out gold. A still more economical standard has, therefore, been evolved which dispenses with the use of gold still further. For internal purposes, gold coins and bullion are not available from the monetary authority. For making payments to foreign countries, however, gold (or foreign currency) is available from the said authority at a rate fixed in terms of the currency of another

country which has a gold standard (gold currency or gold bullion standard). Thus, before September, 1931 when England was on gold standard, the Indian rupee was linked to the British currency at the rate of Re. 1 = 1s. 6d. Gold could not be had in exchange of rupees for internal purposes; but for making foreign payments, gold (or foreign currency) was available at the rate of 1s. 6d. We then, had a gold exchange standard.

Under this standard, therefore, the currency of a country is not directly linked to gold but is indirectly based on it through the medium of the currency of some other country which has a direct gold standard. And by free purchase and sale of gold (or foreign currency or foreign exchanges) the monetary authority keeps the rate of exchange nearabout the fixed parity.

1-c Sterling (or Dollar) Exchange Standard

We have described above three types of one form of monometallic standard, namely, the gold standard. We shall now discuss the remaining two types of monometallic standard, namely, the silver standard and the sterling (or dollar) exchange standard. We first take up the latter.

If the currency of a country is linked to the currency of Great Britain or the United States of America or any other country, and the latter is not on gold, then we have the sterling or dollar or any other exchange standard.

For instance, at present the rupee is linked to the sterling and the latter is off gold. We have, therefore, the sterling exchange standard in India.

Gold exchange standard and sterling exchange standard are often confused even by responsible writers. Students should clearly understand that in both of these standards, i.e., gold exchange standard and sterling exchange standard, the value of currency of one country is fixed in terms of that of another; but in the first case the latter currency is on gold standard, while in the second case it is off gold.

1-b Silver Standard

The monometallic standard in which silver is used for the coinage of standard money is known as silver standard. This standard is subject to capricious and erratic fluctuations because of the enormous quantity of silver mined each year. As such, it has been practically abandoned over a major part of the world. China which clung to silver for a very long time and Hongkong which followed its lead, have also of late, abandoned it. China left the silver standard on November 3, 1935 and Hongkong, five days later.

§ 2. VALUE OF MONEY

Meaning of the Value of Money

Just as the value of all the commodities and services is measured in terms of money, similarly the value of money is measured in terms of *general goods and services*. By value of money economists mean the amount of *goods and services in general*⁷ which one unit of money can purchase; in other words, its *general purchasing power*.

Value of Money and General Price Level

The amount of *goods and services in general* which one unit of money can purchase is called above the value of money. The money price of one (composite) unit of *goods and commodities in general* is called the *General Price Level*.

General Price Level varies inversely with the value of money: if one rises, the other falls. It can be explained with reference to wheat which is being sold, say, at 8 seers a rupee. If the value of a rupee goes up to 16 seers of wheat, what happens to the

7. "*Goods and services in general*" is not a clear expression. It refers to that group of commodities and services which represents the entire mass of commodities and services. This is called the "*representative datum*". The value of money is measured in terms of this composite mass.

J. M. Keynes, however, maintains that the concepts of "*goods and services in general*," and its counterpart "*General Price Level*" are unreal myths. This view is altogether correct and logical. See Keynes's, *A Treatise on Money*, Volume I, Chapter VI.

value of wheat? It goes *down*: formerly it was 2 as. a seer but now it is only 1a. a seer. In the same way it can be shown that the value of money goes *down*, the value of wheat shoots up. What is true of the value of wheat is also true of the value of goods and services in general, i.e., general price level.

Quantity Theory of Money⁹

The value, or purchasing power, of money depends in the first instance on the demand for and supply of money.

Supply of Money—The supply of a commodity means the quantity offered for sale. But it is not usual to speak of offering money for sale. This, however, is merely an accident of language. The money with which people are offering to buy things and services is money offered for sale. The supply of money, then, is the quantity of it which people are wanting to lay out; that is, all the money they have in their possession, except what they are hoarding, or at least keeping by them as a reserve for future contingencies. The supply of money, in short, is all the money in *circulation* at the time.

The Demand for Money—The demand for money consists of all the goods offered for sale. Every seller of goods is a buyer of money, and the goods he brings with him constitute his demand for money.

8. The value of a thing is what it will exchange for. the value of money is what money will exchange for, the purchasing power of money. If prices are low, money will buy much of other things and is of high value; if prices are high it will buy little of other things, and is of low value. The value of money varies inversely with general prices: falling as they rise, and rising as they fall—J. S. Mill, *Principles of Political Economy*, page 279.

9. A detailed statement of the theory is not given here. Those who want to make a detailed study are advised to consult Chabliani, *Indian Currency, Banking and Exchanges*, Chapter II or Thomas, *Elements of Economics*. This theory has been criticized on various grounds and substitutive theories have been propounded, e.g., the Cambridge Formula and the Keynesian Formulas. See J. M. Keynes, *A Treatise on Money*, Volume I, Book III, and *A Tract on Monetary Reforms*.

Now suppose the supply of money has increased and, other things remaining the same, prices have risen. The rise in prices will be in the ratio in which the quantity of money had increased. If money in circulation were doubled, prices would be doubled. If the quantity of money were to be reduced to half, prices would also decline to the same extent. As such, the value of money, other things remaining the same, varies inversely as its quantity¹⁰.

Quantity Theory of Money—This is the celebrated Quantity Theory of Money. It states that every change in the quantity of money in circulation produces, *other things being equal*, a directly proportional change in the general price level or a reverse proportional change in the value of money. If you increase or decrease the quantity of a commodity, its value will certainly fall or rise, but not *proportionately*. In case of money, however, if you increase or decrease its quantity, the change in its value will be proportionate, provided other things are equal.

Other Things Being Equal—This is an important phrase and means that this theory holds good only under certain hypothetical conditions. They are given below :—

(1) *Volume of Trade*—The volume of trade determines the amount of money required by the country; in other words, it determines the demand for money. The theory assumes that the value of trade remains the same. If it increases somehow, each unit of money will begin to be exchanged for more goods and services than before and its value will increase in spite of an increase in its quantity, and *vice versa*.

(2) *Credit Instruments*—Credit instruments sometimes act for money and serve their purpose very well. The quantity of credit has the same relation to the general price level as money. The theory assumes that the supply of credit instruments remains the same.

10. J. S. Mill, *Principles of Political Economy*, Book III, Chapter VIII.

(3) *Velocity of Circulation*—A coin exchanges for goods and services a number of times and does the work of many coins and notes. Thus, if a rupee is used for 100 transactions during a month, it has done the work of 100 rupees. The number of times a coin circulates is known as its "velocity". The effective quantity of money is equal to the actual quantity of money multiplied by its velocity. Changes in the velocity have the same effect on price level as changes in the quantity of money. The theory presumes that velocity remains the same.

The Equation—These relations have been expressed by Professor Irving Fisher as below :—

If P = General Price Level,

M = Quantity of money in circulation,

M' = Quantity of credit money in circulation,

V = Velocity of M ,

V' = Velocity of M' ,

then,

$$P = \frac{MV + M'V'}{T}$$

or,

$$PT = MV + M'V'$$

The theory assumes that T , V , M' and V' remain unchanged; now, if you increase M , P will rise proportionately, and *vice versa*. The value of money depends upon its quantity; hence the name Quantity Theory of Value. In this sense, this theory becomes an obvious truism.

Measurement of the Value of Money

Value of money is an abstract concept and cannot be measured directly¹¹. But the general price level,

11. It cannot be directly measured because the composite character of the "general goods and services" makes their utilisation difficult and in many cases, meaningless.

or a composite price of things in general, which varies inversely with variations in the value of money, lends itself to easy measurement. General price level is measured by *General Price Index Numbers*. The general price level in a standard year is taken to be 100. Similar numbers for other years are calculated indicating a rise or fall, as the case may be, in the general price level. *These numbers which are meant to show variations in the General Price Level are known as General Price Index Numbers*. If the general price level rises, it is presumed that the value of money has proportionately fallen; and *vice versa*.

Construction of Index Numbers—Price index numbers are constructed as below:—

(1) A list of goods and services is made such that they may reflect the variations in prices in goods and services in general.

(2) A period, normal in character, is taken to be the basic period and serves as a standard for comparisons.

(3) Prices for the period concerned are collected from representative localities at the regular intervals and are averaged. The average gives the price of the commodity during the period concerned.

(4) The price of a commodity during the basic period is taken to be 100, and the percentage price for the same commodity in the period concerned is found out by the simple rule of three. This is done with regard to each commodity.

(5) All the percentage prices are then added up and divided by the number of items. This gives the *Index Number* for the period.

Appreciation and Depreciation in the Value of Money

The value of money, like that of any other commodity, is subject to fluctuations. A rise in the value of money (i.e., its purchasing power) is known as *appreciation*; and a fall, as *depreciation*.

Suppose the value of money in terms of wheat was 10 seers a rupee on 1st April, 1940. If on 6th

April, 1940, one unit of money can purchase 11 seers of wheat, its value has *appreciated*; on the other hand, if it can purchase only 9 seers, its value has *depreciated*.

Depreciation must not be confused with *deterioration* or *debasement*. *Deterioration* means reduction in the metallic content of a coin through wear and tear, and *debasement* signifies deliberate reduction in the metallic content of the coin or in the fineness of the metal. *Depreciation*, on the other hand, means a decrease in the value of money as a result of variations in the demand for and supply of money.

Inflation, Deflation and Reflation

The volume of currency should be determined with reference to the legitimate demand for currency in the country. If this is not done and the supply of currency exceeds, or falls short of, the demand for it, grave repercussions are likely to follow.

Sometimes it so happens that the Government deliberately increases the volume of currency in a period of financial stringency till it exceeds the legitimate currency requirements of the country. Such an *abnormal and deliberate increase in the value of currency in excess of the legitimate demand for it*, is called *inflation*. Inflation depreciates the value of money and raises the general price level. During the Great War, many countries inflated their currency. The inflation in Germany was so tremendous that the value of Reichmarks became lower than the paper on which it was printed ! It was called 'hyper-inflation'.

Deflation refers to the contraction of currency to such an extent that it falls short of the demand for it. Deflation appreciates the value of money and depresses the general price level. After the Great War, many countries deflated their currency considerably.

The post-War deflation had to be corrected by a policy of controlled inflation with a view to tone up the depressed world economy. As the word *inflation*

is associated with currency depreciation and the like, *an expansion of currency with a view to correct the effects of past deflation, is often termed as reflation.*

Effects of Appreciation and Depreciation

The appreciation and depreciation of currency cause uncalled for fluctuations in the value of money and price levels, and distort and damage the economic mechanism by disturbing the even basis of trade and industry, and by benefiting some classes at the expense of others. These effects can be discussed under three heads : (a) Effects on industrialists and business men; (b) Effects on consumers; and (c) Effects on debtors and creditors.

Effects of Inflation or Depreciation of Money or Rising Prices—(a) During the period of rising prices, *industrialists make huge profits.* Their (money) cost of production remains more or less the same, and even if it rises, it rises very slowly, while the prices shoot up tremendously. High profits are, therefore, earned. This is also the period of rapid industrial expansion as the profits earned are invested in industries by the industrialists. High profits lead to speculation which entails much loss when the inevitable crash comes. *Business men* also increase their profits as people have money in their pockets and purchase goods freely. The period of inflation, thus, coincides with high profits, industrial expansion, increased employment and general prosperity. (b) *Debtors gain and creditors lose.* Debtors pay to their creditors the exact amount of money they had borrowed (plus interest), but the prices having gone up, it cannot purchase as much goods and services as it could when the loan was given. Creditors, therefore, get less purchasing power than what they had parted with. (c) *Consumers suffer* to the extent that they are required to pay higher prices than before. Industrialists and others, whose incomes increase due to rising prices, do not mind it, but the workers, capitalists and landlords whose incomes are fixed, suffer since their income loses a part of its purchasing power.

Effects of Deflation or Appreciation of Money or Falling Prices—The effects of falling prices are just the reverse of those described above. (a) The profits of the industrialists shrink and a depression sets in. As people do not have sufficient money, they reduce their purchases and factories have, therefore, to be closed down. The outlook becomes pessimistic and unemployment increases. (b) Creditors gain while debtors lose. Debtors pay the amount of money that they had borrowed but as the prices are low at the time of payment, they pay more in terms of goods and services. (c) Consumers benefit as they pay for the goods they consume, lower price than before. This is particularly true of labourers, landlords and capitalists whose incomes are fixed and do not shrink; but not so much of industrialists whose incomes are considerably reduced.

§ 3. GRESHAM'S LAW

Now we come to the interesting law, known as Gresham's Law. During the reign of Queen Elizabeth, English coins had either deteriorated through wear and tear or had been debased by unscrupulous persons. New coins were issued over and over again to improve the matters but they disappeared as soon as they made appearance. The Queen sought the advice of Sir Thomas Gresham into the matter. Sir Thomas opined that *bad money always drives good money out of circulation*; and currency could be improved only by withdrawing all the bad coins from circulation. The tendency of bad money to drive good money out of circulation is, since then, known as *Gresham's Law*.

Scope of the Law

This law is applicable in the following three cases :—

(1) *If coins of the same metal but of varying weight, or quality, or both, circulate together at the same nominal value, the worse coins will tend to drive the better ones from circulation.* The good coins disappear because some of them are kept back from circulation or hoarded, while others are melted down, exported or fraudulently depreciated in weight. Most men, alth-

ough they gain nothing by it, have a lurking inclination to keep a brand new coin and give out the depreciated or debased coin when both have the same value. Those who hoard money prefer good coins for hoarding since their metallic content is greater than that of bad coins. Those who want to melt coins, similarly, prefer the good coins for the same reason. Again, those who want to pay foreigners, export good and full-weighted coins, not bad ones, because foreigners value coins according to their weight. Finally, fraudulent persons, with very slight risk of detection and with certain profit to themselves, clip and sweat the newer coins so as to reduce them to the general level of those in circulation.

(2) *If coins of two precious metals be circulated at a fixed ratio of exchange with one another, the over-valued metal (at the mint) will tend to drive the under-valued metal from circulation.* Suppose in a country two kinds of coins are current — 'G', gold coins, and 'S', silver coins — at the mint rate of $1G = 10S$. Suppose the market value of gold and silver changes in such a manner that the market value of these coins becomes $1G = 15S$. In this case, then, the mint over values the silver coin and under values the gold coin. Consequently, gold coins will disappear from circulation and will be hoarded or melted or exported¹².

(3) *If an inconvertible paper currency be issued in excess of the normal requirements of the country, it will tend to drive precious metals from circulation.* An abnormal increase in the amount of inconvertible paper currency, which is obviously bad money, tends to drive

12. A very good illustration of this type is provided by the Japanese currency. At the time of the treaty of 1858 between Great Britain, United States of America and Japan, the most valuable Japanese coin was *Koban*. It was passing current in Japan for four silver *Itzibus*, but was worth in English money about 18s 5d whereas the silver *Itzibus* was equal only to about 1s 4d. Thus the Japanese were estimating their gold money at about one-third as estimated according to the relative values of the metals in other parts of the world. The earliest European traders trebled their money by buying up the *Koban* at the native rate and selling it abroad, until the natives, perceiving what was being done, withdrew from circulation the remainder of gold. See Laughlin, *Principles of Money*, for such interesting historical examples.

metallic coins, which are good money, from circulation. Metallic coins are either exported or hoarded or melted down¹³.

Limitations of the Law

The Law has three limitations :—

(1) It is applicable to standard money, whose face value is equal to its intrinsic value, and to paper currency only. It is not applicable to token coins. Since the face value of the token coins is higher than their intrinsic value, they are bad coins as against standard coins. But there is no competition between the standard and token coins since they satisfy altogether different types of currency demands. As such, though token coins are bad coins, they do not displace standard coins.

(2) If the total currency of the country does not exceed her normal and legitimate requirements, the law will not operate: since all the coins, good, bad, or indifferent, are needed for circulation, the value of each coin as coin *will* be higher than its value as bullion. But if the total currency exceeds the legitimate requirements, good coins will be withdrawn to the extent of the excess.

(3) Bad money will fail to throw good money out of circulation in case the community as a whole refuses to accept and to circulate it for exchange purposes in view of its worthlessness.

13. Exports of metals, it may be noted, take place automatically. Abnormal increase in the volume of currency raises prices all round. Other countries find it profitable to sell their goods in this country, resulting in an export of precious metals to pay for the imports of goods. The ensuing scarcity of coins encourages hoarding, thus reducing the stock of gold in circulation drastically.

CHAPTER VII

INDIAN CURRENCY SYSTEM

To day, sterling is dancing to the tune of the dollar which, again owing to the peculiar situation of the gold market, the recalcitrance of the courts and the constitutions, the mutual contrariety of the economic policies implicit in the New Deal and its offshoots, and, lastly the vicious circle of the steadily mounting gold stocks financed out of enormous dollar loans, is almost a derelict currency inspite of its firmness and is managed, not by the "24-hour basis" Morgenthau, but by uncontrollable external forces over which America has no influence. In this currency medley, I believe, India can, to a very large extent insulate her economy from the repercussions of international economic disequilibria by pursuing an independent monetary policy—*B P Adarkar*.

§ 1. THE PRESENT CURRENCY SYSTEM

Metallic Currency

Indian currency, like the currency of all other countries of the world, consists of metallic money and paper money. The most important metallic coin is the rupee. It is the principal money of the realm, and unlimited legal tender. Hence it may be called the standard money of India. But unlike standard money, its intrinsic value is less than its face value and it is not open to free coinage. In these respects, it partakes the nature of token money. It is, as such, neither wholly the standard money nor wholly the token money. It is best described as the Token Standard. When we say that the rupee is the token standard, we mean that though in coinage it is just like a token coin, it does perform the functions of the standard coin all the same. Eight-anna silver coins are also unlimited legal tender, but they are not standard coins. Then there are 4-anna, 2-anna and 1-anna pieces made of silver or nickle, which are limited legal tender.

Paper Currency

The paper currency consists of notes of rupees 5, 10, 50, 100, 500, 1,000, and 10,000. These notes are promissory notes convertible into silver rupees on demand. They were formerly issued by the Government of India, but since the enactment

of the Reserve Bank of India Act in 1935, their issue has now been entrusted to the Reserve Bank¹.

Monetary Standard

As the value of the rupee is fixed in terms of sterling which is not on gold standard, our monetary standard is the sterling exchange standard. Sterling can be had in exchange for our currency at the rate of 1 rupee = 1s. 6d.

The method in which this ratio is maintained is, indeed, interesting. Various methods have been tried from time to time.

(1) Sale of Council and Reverse Council Bills. This was the first method to be adopted. Details about this method are given in the following section (§ 2.)

(2) Purchase and sale by the Government of India of sterling bills in Indian market. This policy was adopted after superseding the above policy.

(3) Since the establishment of the Reserve Bank of India, the obligation of maintaining the ratio has been put on its shoulders. According to the Reserve Bank Act, Section 40, "The Bank shall sell to any person who makes a demand in that behalf at its office in Bombay, Calcutta, Delhi, Madras or Rangoon, and pays the purchase price in legal tender currency, sterling for immediate delivery in London, at a rate not below one shilling and five pence and forty-nine-sixty-fourths of a penny for a rupee; Provided that no person shall be entitled to demand or buy an amount of sterling less than ten thousand pounds". Section 41, similarly, states: "The Bank shall buy from any person who makes a demand in that behalf at its office in Bombay, Calcutta, Delhi, Madras, or Rangoon sterling for immediate delivery in London, at a rate not higher than one shilling and six pence and three-sixteenths of a penny for a rupee; Provided that no person shall be entitled to demand or sell an amount of sterling less than ten thousand

1. Also read the Present Position of Paper Currency in Sec. 4 below.

pounds; Provided further that no person shall be entitled to receive payment unless the Bank is satisfied that payment of the sterling in London has been made."

§ 2 IMPROVEMENTS IN THE CURRENCY SYSTEM OF INDIA

The Problem of the Standard

The crux of the currency problem in India is the question of the monetary standard which we should adopt. At present, we have the sterling exchange standard: the quantity of money in circulation is so adjusted as to minimise the fluctuations in the value of the rupee above and below 1s. 6d. The Reserve Bank of India has been put under the obligation of taking all steps to prevent fluctuations beyond certain points nearabout 1s. 6d. level. The way in which the rupee is managed takes no account of the employment of human and natural resources and stability in the internal value of the rupee. It occasionally happens that the Government, in their attempt to keep the value of rupee at 1s. 6d., have to adopt a policy which causes considerable unemployment in the country and gives a rude shock to the internal price level. This, of course, is not on all fours with the economic interests of this country. It is not desirable that the rupee should be linked to sterling to the complete ignorance of the internal economy. What we require is a standard which should primarily promote our best national interests. In technical language, we do not want any external or dependent standard, only an internal or independent standard, which looks to the best interest of the internal economy of the country, can suit us. As Professor B. P. Adarkar rightly states, "It has by now become a common place of currency literature that for a country which has a wider ambit of internal than of external trade, mere exchange stability, which is secured regardless of internal stability of production, prices and employment, is not a proper justification for a standard. For this reason, so far as the question of the appropriate standard is concerned, it is beyond the shadow of a

doubt that an independent standard is to be preferred to an exchange standard in the case of India"².

The Problem of the Ratio

But in spite of the definite superiority of the independent standard over an exchange standard, India has had one or the other kind of the latter (i.e., exchange standard) since the very beginning, while now the sterling exchange standard has been adopted in its purest form. It appears that the Government of India are not in a mood to give up the eternal embrace of the exchange standard in favour of internal standard. As such, the ratio at which the rupee is linked to sterling becomes an important issue. At present one rupee is equal to 1s. 6d. But there has been a growing volume of opinion in favour of a lower ratio, 1s. 4d. or even less.

An unnaturally high ratio is very injurious to the country. It encourages imports. If, for instance, the ratio is raised from 16d. to 18d. a rupee, an English article costing 18d. can now be had in India for one rupee in place of one rupee and two annas as before. The decrease in price naturally increases demand. Similar reasoning will disclose that a high ratio decreases exports. These twin tendencies of increasing imports and decreasing exports make the balance of trade progressively unfavourable, resulting either in international indebtedness or capital dissipation. Moreover, it depresses prices and paralyses economic mechanism. This has actually happened in our country. The falling merchandise balance from 1926 onwards, the heavy national borrowing between 1926 and 1931, and the gold exports after 1931, are positive proofs of the unnaturally high level of the ratio. Another proof, if such were necessary, is the drastic depression in the internal price level since 1929, or even earlier, though price levels in other countries of the world have occasionally had short periods of progress since then. It is now an open secret that the Government want to maintain a high ratio with a view to safeguard the "triple interests", viz., the British

2. B. P. Adarkar, *The Indian Monetary Policy*, ix

exports, British officials in India and the Central Budget. Let us hope the Government will learn to look to the internal progress of the country rather than to such superficial ideals instead³.

§ 3 HISTORY OF INDIAN CURRENCY

I. 1835-1893. The Silver Standard

Before the year 1835, there were about one thousand coins of different varieties and weight in circulation in this country, issued by various Hindu and Mohammedan rulers. This bewildering multiplicity of coins greatly hampered trade. Therefore, in 1835 the East Indian Company made the present rupee of 180 grains of silver, 11/12ths fine, as the standard coin of the realm. Mints were opened to the free coinage of silver on the payment of mintage. A full-fledged silver standard was, thus, established.

The price of silver began to fall from 1873 onwards due to the opening of new and very productive silver mines in America. The gold value of the rupee, which was normally two shillings, ultimately reached the one shilling level. It upset the even basis of trade; in particular, it drastically curtailed imports from foreign countries. The British officials in India also suffered in the matter of remittances to England, because each rupee could now be exchanged for 1s. only instead of 2s. as before. The Government of India had to pay annual Home Charges to Great Britain in sterling and, in terms of rupees, their commitments became almost doubled. The question was, therefore, referred to the Herschell Commission, whose Report was published in 1893.

II. 1893-1898. Breakdown of the Silver Standard

In accordance with the recommendations of the Herschell Commission, mints were closed to the unrestricted coinage of silver in 1893 and the Government ceased to coin fresh rupees. The result was that as soon as circumstances pushed up the demand for currency, the value of the rupee also rose.

³ For detailed discussion of this issue see B. P. Adarkar, *op. cit.* Also Amar Narain Agarwala, *Economic Essays*.

In 1898 its value touched the level of 1s. 4d., the rate fixed by the Herschell Report as ideal. The Fowler Committee was then appointed in 1898 to consider what further steps should be taken.

III. 1898-1914. Gold Exchange Standard

The Fowler Committee suggested that the exchange value of rupee should be fixed at 1s. 4d.; that the British Gold Sovereign should be made legal tender and current coin in India; that the Indian mints should be thrown open to the unrestricted coinage of gold. The Committee virtually recommended the establishment of the gold currency standard. The Government accepted these recommendations but did not put them in practice. The gold mint was not set up. Gold sovereigns were introduced but they soon came back to the treasuries. The Government policy gradually gravitated towards a new system which neither the Fowler nor the Herschell Commission had ever contemplated. This was the gold exchange standard⁴. The value of the rupee was pegged at 1s. 4d. and kept thereabout by the purchase and sale of council and Reverse Council Bills. (A) *Council Bills*. When the balance of trade was favourable to India and the demand for rupee bills in London was considerable, the Secretary of State for India sold Council Bills in London at the rate of 1s. 4d. plus a fraction not more than the cost of transporting gold from England to India. These council bills were sent by British debtors to Indian creditors who encashed them at Government treasuries. In this way the possible increase in the exchange value of rupee beyond 1s. 4d. was checked. (B) *Reverse Council Bills*. When the balance of trade was unfavourable to India and there

4. This system has been designated by some writers as the gold Exchange standard. Others headed by Dr. L. C. Jain, have called it Gold Sterling standard. (See Dr. L. C. Jain, *The Monetary Problems of India*, p. 89) Perplexed by this sort of difference among the authorities on this subject, some writers state, "Thus was established the Gold Exchange Standard, or as some people choose to call it, the sterling Exchange Standard." (R. N. Mathur, *Introduction to Money, Exchange and Banking* p. 128) In fact, the standard was the Gold Exchange standard. For a discussion of this topic, see Amar Narain Agarwala, *Pure and Applied Economics in India*, *Mysore Economic Journal*, vol. 24, No. 11, 1938.

was demand for sterling bills in India, the Government of India drew Reverse Council Bills on the Secretary of State for India and sold them in India at 1s. 4d. *minus* a fraction not exceeding the cost of transporting gold from India to England. In this way the possible fall in the exchange value of the rupee much below 1s. 4d. was checked. By the technique of the Council and Reverse Council Bills the exchange value of rupee was stabilized near about 1s. 4d.

The currency policy of the Government was put to serious criticism by the people of the country, particularly the advocates of the gold currency standard. The Government, therefore, appointed the Chamberlain Commission in 1913 which blessed the gold exchange standard and recommended its continuance.

IV 1914-1918 The War period

The Report was in the hands of the Government shortly before the Great War broke out. During the first year of the War, people lost confidence in the Government. Deposits were withdrawn from the Post Office Savings Banks and currency notes were presented to the Government for conversion into gold, so much so that the Government were obliged to suspend the issue of gold. There was also a huge demand for exchange remittances. Fortunately, the situation soon came under control and confidence was restored. After 1915, however, the situation became seriously critical. Exports from India to the Allies increased tremendously while imports from them shrank, with the result that the balance of trade turned substantially in our favour. Moreover, heavy expenditure was incurred in India on behalf of the British Government which gave rise to claims on the latter. In the beginning the Council Bills were issued to meet the demand at 1s. 4d. a rupee, but very soon the issue of the bills became so tremendous that the Government of India found it difficult to encash them. They were indeed in great trouble for they could not import gold or silver for coinage purposes, economically and safely. The value of silver, in fact, had increased so much that people found it profitable to melt the

rupee and to sell it as bullion. No other course was left to the Government but (a) to restrict the scale of Council Bills, which were sold at increasingly high rates, and (b) to issue notes of the denominations of rupee 1 and rupees $2\frac{1}{2}$ as fiduciary issue. Evidently, then, the pre-War system of stabilization by selling Council Bills and Reverse Council Bills in unlimited quantities at a fixed rate of exchange, broke down. The Government now sold Council Bills only in limited quantities and at rates which were shooting up frequently. Exchange was allowed to rise from 1s. 4d. in 1914 to 2s. 4d. in 1918.

V. 1919-1925. The Babington-Smith Committee

After the War was over, the Government appointed the Babington-Smith Committee to advise on the future policy of Indian exchange and currency. The Committee recommended the re-introduction of gold exchange standard. In fact, their ultimate ideal was gold currency standard and, therefore, they recommended that the sovereign should be made legal tender at the rate of Rs. 10 = 1 sovereign or (Rupee 1 = 2s). The high ratio of two shillings was recommended, for the Committee believed that the high price of silver had come to stay.

The anticipations of the Committee were, unfortunately, completely upset by the turn which the events took. The value of silver fell and the balance of trade became unfavourable to India. The Britishers, who had made war profits in India, began to remit them to England at this favourable rate of exchange. Indian debtors also hurried to pay their British creditors. Such a heavy demand for sterling caused the value of the rupee in terms of sterling to fall. The value of the rupee could not be maintained at 2s gold (which was equal to 3 shillings sterling). Attempts were then made to hold it at 2 shillings sterling but only failure was in store. And in 1922 the Government had to refuse to sell the Reverse Councils. The exchange was left to find its own level.

VI. 1926-1931. The Hilton-Young Commission

In 1924 the ratio came to be stabilised at 1s. 6d.; and in 1925 the Government appointed the Hilton-

Young Commission to advise the lines of the future currency policy. The Commission recommended the adoption of the gold bullion standard at 1s. 6d. ratio, and the purchase and sale of gold by the State with certain qualification⁵.

The Government adopted these recommendations and an Act was passed which imposed legal obligation on the Government to buy gold, and to sell gold or, at the option of the Government, sterling. Thus the standard actually adopted by the Government was neither the gold-bullion standard nor the gold exchange standard but a hotch-potch standard becoming one or the other at their sweet will under the stress of the circumstances.

VII. 1931 Onwards

In 1931 England went off gold standard. India followed suit and the rupee was wedded to widowed sterling at 1s. 6d. At present we have a sterling exchange standard.

§ 4. THE INDIAN PARER CURRENCY SYSTEM

Prior to 1861, currency notes were issued by the Presidency Banks of Madras, Bombay and Calcutta. The maximum issue was fixed, and a metallic reserve of 33 per cent was kept.

In 1861 the Government themselves took over the right of issuing paper currency. Notes of Rs. 4 crores were to be issued against securities; but beyond that figure, a cent per cent metallic reserve had to be kept. In 1893, the amount of notes which could be issued against securities was raised from Rs. 4 crores to Rs. 14 crores and in 1914 to Rs. 20 crores. During the War this figure was pushed up to Rs. 120 crores when Re. 1 and Rs. 2½ notes were also issued without any metallic backing.

5. The essence of the proposal was "that the ordinary medium of circulation in India should remain as at present the currency and the silver rupee, and the stability of the currency in terms of gold should be secured by making the currency directly convertible into gold for all purposes, but that gold should not circulate as money. It must not circulate at first and it need not circulate ever".

The Babington-Smith Committee recommended a 40 per cent reserve against the entire note issue and the maximum limit of notes issued against securities was fixed by them at rupees 130 crores. They also suggested that in a busy season an emergency currency may be issued against the export bills of exchange. The Government accepted these recommendations with the only difference that the percentage of the metallic reserve was fixed at 50 per cent instead of 40 per cent as recommended by the Commission.

The Present Position⁶

With the enactment of the Reserve Bank Act, the paper currency in India has entered on a new phase. According to this Act, the sole right of issuing notes has been vested in the Issue Department of the Reserve Bank. The Issue Department is quite separate from the Banking Department and the sole liability of the former is with regard to the notes issued. The assets of the Issue Department must be equal to the value of the total notes issued. The relevant provisions regarding assets behind the notes are as below⁷ :

(1) Of the total amount of assets, not less than 40 per cent shall consist of gold coins, gold bullion or sterling securities (provided that the amount of gold coins and gold bullion shall not at any time be less than 40 crores of rupees in value).

(2) The remainder of assets shall be held in rupee coins, Government of India rupee securities and certain specified kinds of bills and promissory notes (with certain limitations on the amount of *Government of India Securities*).

(3) Of the gold coins and gold bullion held as assets, not less than 17/20ths shall be held in British India.

The present system of note issue is safe as well as elastic. Its most prominent feature is the issue of

6. It may be read with § 1.

7. *Reserve Bank of India Act, 1934, Sec. 33.*

notes by the Reserve Bank on the proportional reserve system—a gold reserve of 40% is kept against the entire issue.

This 40 p. c. reserve is not irreducible minimum. If the Reserve Bank feels the need of issuing more currency but has not got adequate gold to satisfy 40 p. c. requirement, this percentage can be reduced on the payment of a tax⁸.

Comparison With the Old System

Under the old arrangement, the paper currency was issued by the Government of India. The Government of India could increase or decrease the amount of currency according to its own requirements. The interest of the business community was not always taken into consideration. The Imperial Bank was, however, allowed to ask the currency authorities to increase the currency to the extent of 12 crores of rupees only on the security of prescribed hundies and other securities whenever there was monetary stringency.

The present system is an improvement over the old system in the following respects :—

1. For the first time in India, a Bank has been given the sole right of note issue. It is an admitted fact that the State is an inefficient agency for the note-issuing function. Due to the following reasons the present Bank issue is superior to the old State issue :
(a) The needs for currency vary from time to time and in varying proportions. A government cannot possess an accurate knowledge of such changes in the demand because not being in direct touch with the

⁸ *The Reserve Bank Act* provides that in respect of any period during which the holding of gold coins, gold bullion or sterling securities (i.e., gold reserve) is reduced below 40, the bank shall pay to the Governor General in Council a tax upon the amount by which such holding is reduced below 40% (of the aggregate value of notes issued). This tax shall be equal to the bank rate for the time being in force, with an addition of 1 p. c. per annum when such holding exceeds 32 p. c. of the total amount of the assets and further 2 p. c. per annum in respect of every further decrease of 2 p. c. or part of such decrease.

conditions in the financial, commercial and industrial world, it is not sensitive to these variations. As such, it cannot adjust the supply of paper currency to the demand for it. This is not so in the case of a Central or Reserve Bank which remains in constant touch with various sections of the business community. (b) The real danger involved in the issue of paper by a Government consists in the fact that "political considerations and the pecuniary needs of the State rather than considerations of a sound monetary economy are likely, sooner or later, to become the determining factor. There will be a risk of excessive issue and consequent depreciation."⁹ These two considerations, one economic and one political, explain why the present system is an improvement over the old system.

2. Our paper currency has now become elastic¹⁰. Under the old arrangement the paper currency could be increased to the extent of Rs. 12 crores only. But under the present system, there is no limit to the extent of possible extension. For every Rs. 40 worth of gold reserve kept by the Bank, it can issue Rs. 100 worth of notes. This provision will itself provide sufficient scope for elasticity. But in case there is need for more currency and the same is not permitted by the insufficiency of gold reserve at 40 p. c. level, this percentage can be reduced on the payment of certain taxes. And the reduction can go on indefinitely even if the gold reserve may be allowed to drop down to zero.

§ 5. HISTORY OF PRICES OR VALUE OF MONEY IN INDIA

We discussed in the preceding chapter that the value of money is invariably co-related with general price level so that a study of general price level gives us a good idea of fluctuations in the

9. See Kisch and Elkin, *Central Banks*.

10. Elasticity of currency implies the capacity of currency to increase or decrease as demand for it increases or decreases, and to the extent to which it increases or decreases.

value of money. We shall discuss below the price index numbers in India.

Price Index Numbers in India

The price index numbers in India are found in the official publication called, "*Index Numbers of Indian Prices*" issued by the Department of Commerce and Industry of the Government of India, since 1905; but these index numbers are not supposed to be very reliable¹¹. Below is traced the history of prices in India on the basis of the available information.

History of Prices in India

The following index numbers indicate the general course of prices in India since 1861, with 1863 as the basic year. They are based on the wholesale prices of 39 articles.

Year	General Index Number	Year	General Index Number
1861	90	1917	196
1865	107	1918	225
1870	102	1919	276
1873	100	1920	281
1875	94	1921	236
1880	104	1923	215
1885	87	1925	227
1890	100	1926	216
1895	104	1927	202
1900	116	1928	201
1905	110	1929	203
1910	122	1930	171
1913	143	1934	119
1914	147	1935	127
1915	152	1936	125
1916	184		

1861-1865. Rise in Prices

As is evident from the above table, this was the period of rise in prices. Due to the American Civil War.

¹¹ For instance see Vakil and Munranjan, *Currency and Prices in India*, p. 140; also Bowley Robertson Committee Report, p. 44.

extensive exports of cotton at high prices were made from this country, which brought in it an enormous quantity of precious metals. The coinage of silver also increased and prices shot up.

1866-1875. Fall in Prices

During this period, the prices, on the whole, showed a tendency to decline, except for a sudden break between 1876 and 1880 when they tended to rise owing to famine. The fall in the prices was due to following causes : (a) *Scarcity of gold*. The world production of gold had declined while the demand for it had increased as the gold standard was adopted more extensively. (b) *Stoppage of free coinage of silver*. During this time mints were closed down for the free coinage of silver, which checked the issue of silver currency freely. (c) *Increase in trade*. The value of trade had increased due to improvements in the arts of production and cheap freight, the latter as a result of the opening of the Suez Canal and the construction of railways.

1885-1893. Rise in Prices

During this period, the production of silver increased enormously. Germany and other European countries demonetised silver which found its way to India which was on silver standard. The heavy coinage of the rupee pushed up prices.

1893-1914. Rise in Prices

During the period under review the price level was high. According to the *Prices Enquiry Committee*, the main internal causes which pushed up prices were: (1) Shortage in the supply of agricultural commodities due to famine etc. (2) Lower cost of transport due to the construction of railways. (3) Improvement in the general banking and credit facilities in force. The external causes included the shortage of staple commodities, increase in the production of yellow metal and improvements in the credit facilities.

5. 1914-1920. Further Rise in Prices

The pre-War tendency of prices to rise continued

during this period with increasing vigour owing to the War. Imports from foreign countries were drastically curtailed since they were busy with War and there was scarcity of shipping facilities, while the rates of insurance had risen sky-high. India exported goods to the Allies which brought much wealth to her. The breakdown of the railway system damaged the distributive system and made way for profiteering.

The famine of 1918-1919 greatly reduced the supply of agricultural commodities. The currency was greatly inflated due to favourable balance of trade which was accentuated by the floatation of war loans. The peak was registered in the year 1920 when the index number rose to 281 as against 174 in 1914.

6. 1921-1929 Slump in Prices

Prices began to decline from 1921 very rapidly. The sale of Reverse Council Bills deflated the currency. The unfavourable balance of trade led to the export of the yellow metal. The unnaturally high ratio of 1s. 6d also did its work. Finally, the world conditions had a depressing effect on Indian prices. Prices fell drastically after the Wall Street Crash in America in October 1929 which paved the way for a world depression.

The prices began to rise slowly after 1933. The Calcutta wholesale price index number which stood at 89 in 1934 increased to 91 in 1935 and remained steady at that figure in 1936. In January 1937, it rose to 98, and in August, to 105 due to the rearmament campaigns, boom conditions and speculations. Since then there set in an economic recession which depressed the prices to 96 in March 1938, and to 94 in April of the same year. Since the outbreak of the present war prices have shot up and profiteering¹² has made its appearance. Price control schemes have been introduced, but still prices are rising.

12. For an elementary discussion of "Profiteering" since the present War, See Amar Narain Agarwala, *Profiteering*, in the *Social Order* (Allahabad), March 10 1940

CHAPTER VIII

CREDIT AND CREDIT MECHANISM

Credit is an exchange in which one party renders a service in the return made by the other falls in the future.—*Kinsé*

§ 1. CREDIT

Meaning and Definition of Credit

the word 'Credit' has various meanings and is used in a variety of senses. It has an economic sense, a business sense, an accounting sense and a general sense.

(a) *Its Economic Sense*—We usually speak of a cash transaction and a credit transaction. By cash transaction we mean a transaction in which cash is paid at the time of the purchase of a commodity or service. Credit transaction, on the other hand, implies a transaction in which the payment of cash is postponed for a future date. In this sense, which is the economic sense of the term, *credit implies the postponement of payment*. Jevons aptly describes credit as 'nothing but the deferring of a payment.'

(b) *Its Commercial Sense*—In commercial parlance, the word 'credit' generally signifies the financial reputation of a business man or a business house. Credit of a business man is based on (i) his business ability and (ii) his honesty. If the credit of a business man is good, he can borrow large sums, a privilege denied to a man of little or doubtful credit. This implication of the word 'credit' is closely related to its economic sense.

(c) *Its Accounting Sense*—Accountants use the word credit to mean the right-hand side of an account.

(d) *Its General Sense*—Credit, in ordinary language, also means 'trust' or 'praise'.

It is, of course, the economic sense of the term 'Credit' which is of special importance to the students

of Economics, and in which it is habitually used by economists¹.

Essentials of Credit

Credit involves three essentials :—

(1) *Exchange or Transfer of Value*—The exchange or transfer of something valuable from one party to the other is an essential element of credit. Unless some goods or services have been transferred by one party to the other, the question of the postponement of payment (i. e. credit) cannot arise².

(2) *Time*—Time is involved in credit. In other words, every credit transaction involves futurity. It is, of course, the postponement of payment to a future date which makes a transaction 'credit' transaction. If the payment is made immediately it will become a cash transaction, pure and simple.

(3) *Confidence*—The most important and basic element of credit is confidence. Unless one has confidence (a) that the borrower is carrying on a profitable business in an efficient way, so that he would have the wherewithal to pay back the money at a future date; and (b) that he is *honest* and would be willing to pay back his liability when he is able to do so, one would not grant credit. Confidence, which is based on the economic and moral qualities of the borrower, is the fundamental basis and the most important element of credit³.

1. Credit has been defined by various writers in different ways. For instance, McLeod speaks of credit as the present Right to a Future payment. L. Walras calls credit as 'the lending of capital'. Carlo F. Ferraro regards credit as 'the whole of those economic conditions because of which men consent to make payments in the present on the promise of repayment in the future'.

2. Some text book writers mention *amount* as an element of credit instead of *exchange*. The word *amount* is, however, vague, inexpressive and of doubtful meaning. In my opinion it should not be used in this present context.

3. The element of confidence is so important that 'credit' is now applied by some writers to that belief in a man's probity and solvency which will permit of his being entrusted with something of value belonging to another, whether that 'something' consists of money, goods, services or even credit itself as when one man entrusts to another the use of his good name and reputation.—S. E. Thomas, *Elements of Economics*, page 433.

Importance and Utility of Credit

The importance of credit in the present age is too obvious to need detailed discussion. If you carefully see all around you, you will find that in every walk of economic life credit plays a vital part. The retailer purchases goods from the wholesaler on credit. The wholesaler, in his turn, gets credit from the manufacturer. The manufacturer, again, gets capital, raw materials etc., on credit. In this way the entire economic structure is bound together by the string of credit. That is why the failure of one firm is often the fore-runner of the failure of other firms operating in similar and dissimilar business fields alike. Large scale production, which is one of the most remarkable characteristic of the present age, has been made possible by credit in a very definite sense. Again, *credit institutions* (i.e., banks) and *credit instruments* (i. e., written evidences of credit transactions which are used more or less like coins and currency notes, such as cheques and bills of exchange) are the most vital constituents of the economic structure of a country. The importance of credit can, therefore, be easily realised.

The main advantages of credit are the following :—

(1) *Credit gives rise to credit instruments* which serve the purpose of metallic currency. This is advantageous in three respects—(a) Credit instruments constitute a *cheaper medium of exchange* than metallic coins. (b) Credit instruments are *more convenient* than metallic currency. For instance, a cheque of Rs. 100 can be easily written, but the counting of coins worth Rs. 100 and the ascertaining that they are all genuine, takes much time. (c) Metallic coins cannot fully meet the *currency requirements* of the present-day society and credit instruments fill the gap with great efficiency.

(2) A natural corollary of the foregoing utility of credit is that it makes the *transmission of money to distant places cheap and easy*. If you have to pay your creditor at Madras Rs. 1,000, you can send silver coins, but much time, labour and money will be

saved if you send him just a bank draft⁴ of that amount.

(3) *It makes possible the collection of unspent parts of the incomes of the people.* Banks mobilize the financial resources which might remain idle otherwise, by offering attractive rates of interest. The habit of thrift is thus inculcated in the masses.

(4) The vast reservoir of capital formed by collecting tiny streamlets and personal savings, is allowed to flow out into the hands of entrepreneurs with brain and acumen but without adequate capital for carrying on business. Thus *credit encourages production*. Not only this; by enabling payments to be postponed till it is convenient for the borrower to make them, it also diminishes difficulty and hardship.

(5) *Credit minimises price fluctuations.* When a boom is imminent and prices are looking up, a check on credit expansion is likely to keep prices stable. On the other hand, if a depression is about to set in and prices are going down, an expansion of credit might prevent its occurrence. Again, when trade is reviving slowly after a period of depression, gradual and systematic expansion of credit may be expected to bring up the prices to the pre-depression level.

(6) *Credit enables governments to obtain possession of funds with which to meet emergencies when no other means are available for the purpose.*

(7) *Credit enables individuals to tide over temporary financial difficulties.* For instance, it makes possible the purchase of goods for consumption purposes pending the receipt of income.

Dangers of Credit

Credit, which is the source of so many benefits and advantages, is also attended with some dangers. Credit is subject to human control and if that control

4. A Bank Draft is in simple language a letter given by one bank office to its own branch or Head Office situated at some other place instructing to pay a definite sum of money to the person named therein.

is not exercised with due caution and intelligence, grave repercussions are likely to follow. The main dangers are the following:—

(1) *The liability of credit to be issued in excess is its most important disadvantage.* The issue of credit is a profitable job—the larger and more numerous the loans a banker gives, the more the interest it earns; and the larger the credit a business man allows, the higher the sales he makes. As such, there is always the danger of its being over-issued beyond the legitimate business requirements. The danger becomes particularly great during the time of business prosperity when unwise credit expansion often leads to excessive zeal, over-production and speculation. To safeguard against this danger, the institution of Reserve or Central Bank has been devised.

(2) *Credit enables a man of doubtful ability to start a speculative and unprofitable business, only to ruin himself and others who have granted him considerable credit.* Again, a business man may continue a losing business with the help of borrowed capital. He may in this way disguise his financial weakness and increase his financial commitments only to make the consequences of his eventual failure more wide-spread and disastrous. Fortunately, people have become alive to this danger and a thorough investigation at the time of giving credit is found to be a dependable safeguard.

(3) *Credit enables consumers to obtain money which they often squander away recklessly and become financial wrecks.* In our own country, a fair share of the rural indebtedness is the result of the borrowing of money for consumption purposes.

(4) *Modern credit organization leads to the formation of monopolies and combinations and to central control, which use unfair methods of competition to crush their competitors, increase prices and exploit labourers.* This danger is sought to be checked by law's against unfair competition and combination.

/ Credit and Capital

Whether credit is capital or not, is an oft-

debated point. There has been great difference of opinion amongst economists on the subject and though the controversy has now been relegated to the background because of its theoretical nature, it has not been made absolutely free from the fog of confusion. 'Capital', as we all know, is that part of wealth which is used for further production of wealth. To decide, then, whether credit is capital or not two questions arise :

(1) Is credit wealth ?

(2) Is it used for further production of wealth ?

(1) Credit is an abstract concept; but its objective form is the credit instrument. Credit instruments serve the purpose of media of exchange. A man who possesses a credit instrument has a claim on somebody and can get cash in exchange for it. As such, like currency or money, credit instruments are certainly wealth.

(2) When credit is taken for productive purposes, evidently it helps in further production of wealth and is, therefore, capital. But if it is used for consumption, it is, of course, not capital.

It appears, then, that *productive credit is capital*. But this statement is sometimes challenged. It is said that it is true from the viewpoint of the borrower and lender but not true from the viewpoint of the society. For the credit instrument is only a representative of capital; and just as your reflection in a mirror does not make two of you, similarly a credit instrument does not increase the capital it represents. Credit thus cannot create capital. "Credit", says Ricardo, "does not create capital; it only determines by whom capital should be employed." Similarly Mill writes, "Credit being only the permission to use the capital of another person, the means of production cannot be increased by it but only be transferred."

There seems to be much sense in this argument. But sometimes credit is granted by bankers far in excess of the capital they possess. Roughly, it has been estimated that if a banker possesses Rs. 10,

he can grant a loan of Rs. 100, because depositors do not demand more than 10% of their deposits at any particular time. In so far as this happens, credit certainly creates capital.

Moreover, in the above argument it is assumed that credit is merely the transference of *capital* from one party to another; this is not always a fact. Sometimes the owner of money does not use it productively but keeps it as a hoard. Its transference to other person for productive use is, therefore, the transference of *idle resources* to some other man for being used as capital. In so far as this happens, credit again may be said to create capital.

Credit Mechanism

In these days of enormous credit and efficient organisation, a well-organised credit mechanism has been set up to make credit arrangements easy, convenient and safe. Its two important constituents are : (a) *Credit Instruments* which are the written evidences of credit transactions, e. g., Bills of Exchange, Promissory Notes etc., and (b) *Credit institutions*, i.e., Banks, which receive deposits and lend money to the borrowers. We shall study them in the following sections.

§ 2. CREDIT INSTRUMENTS

Meaning

In modern society, credit transactions are evidenced by written documents containing an undertaking to pay a definite sum of money. They are known as credit instruments. The important credit instruments are promissory notes, currency notes, bills of exchange, cheques, drafts and *hundies*.

Credit Instruments and Money

Credit instruments are given and accepted in discharge of debts just like money, but there are certain points of difference between money and credit instruments :

- (1) Money is always legal tender : a debtor can legally compel his creditor to accept it in due dis-

charge of debt. Credit instruments, however, do not enjoy this privilege.

(2) Because of the legal tender character, money is *generally acceptable*. A shop-keeper accepts rupee coins from the buyer because he knows that others would unhesitatingly accept them. This is not the case with credit instruments. A person accepts a cheque or a *hundi* from another only if he is confident that the cheque or the *hundi* will be duly honoured. In the absence of this certainty, he will refuse to accept it. Credit instruments are, therefore, only *specialty acceptable*.

(3) Finally, credit instruments are written undertakings to pay money and must necessarily be different from money. They are, in a limited sense, substitutes for money.

We shall now discuss the chief forms of credit instruments.

Promissory Notes

Definition—A promissory note has been legally defined as an instrument in writing (not being a bank note or a currency note), containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Parties to a Promissory Note—There are two parties to the promissory note: (1) the person who signs the note and thereby undertakes to pay, called the *maker*; and (2) the person to whom money is to be paid, called the *payee*.

Demand and Time Promissory Notes—A promissory note contains a promise to pay money either on demand, when it is called a Demand Promissory Note, or after some time, when it is described as a Time Promissory Note.

The notes issued by the Reserve Bank are promissory notes but they have been specifically excluded from the legal definition of the term. Promissory notes, other than bank notes or currency notes, are

written on stamped papers, the value of the stamps being *ad valorem*, i.e., it varies according to the value of the document. The following is an example of a promissory note.



Rs. 300

Two months after date, I promise to pay to Messrs. Ramji Lal Shyamji Lal and Co., or order, the sum of Rupees Three Hundred only for value received.

For Narayan Press,
(Sd.) G. P. Tiwari

Bank Notes and Currency Notes

Bank notes or currency notes are promissory notes, containing as they do the promise of the Government or the Central Bank to pay a certain sum of money on demand to the bearer of the instrument. If a note is issued by the Government, it is known as Currency note; but when it is issued by the Central Bank, it is known as the Bank note. Bank or Currency notes, though credit instruments, are, in fact, money since they are always legal tender. As such, notes differ from other forms of credit instruments in all the respects in which money differs from the latter.

Bill of Exchange

Definition—A bill of exchange is legally defined as an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument. In simple words, a bill of exchange is an order from a creditor to the debtor to pay a certain sum of money to himself or to a specified person or to the bearer.

Parties to a Bill—There are three parties to a bill of exchange—the drawer, the drawee and the payee. The person who draws or makes the bill, *i.e.*, the creditor, is called the *drawer*; the person on whom the bill is drawn, *i.e.*, the debtor, is called the *drawee*; while the person who is authorised in the bill to receive the payment is known as the *payee*.

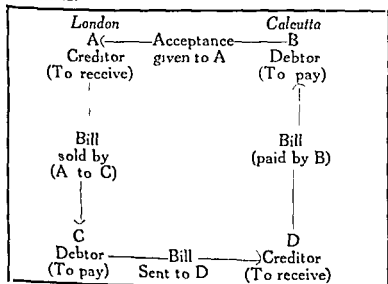
Demand and Time Bills—A bill of exchange may be payable on demand when it is known as Sight or Demand Bill, or it may be payable after a specified period when it is known as Time or Usance Bill. In the case of Time Bills, three days of grace are added to the specified time in order to arrive at the due date. No such days of grace are allowed in Demand Bills. Time Bills must pay an *ad valorem* stamp duty which is not charged on Demand Bills.

Acceptance—A bill, after it is properly written, is presented to the acceptor for his acceptance. He accepts it by writing the word, 'accepted' on the face of the bill with his signature below it. After acceptance a bill becomes a *pukka* document binding on the acceptor. It is then known as Acceptance. The following is an example of a bill of exchange:

Rs. 700	Allahabad April 15, 1940
<div style="border: 1px solid black; width: 100px; height: 100px; margin: 0 auto;"></div> <p>Stamp</p>	<p>Two months after sight of this bill, pay to me or my order the sum of rupees seven hundred only for value received.</p> <p style="text-align: right;">For Kitab-Mahal, Allahabad S. Niwas Proprietor.</p>
To,	The Narayan Press, Allahabad.

This bill has been drawn by the Kitab-Mahal, Allahabad (the drawer) on the Narayan Press, Allahabad (the drawee). Kitab-Mahal is specified as the payee. The bill will be accepted by the drawee by writing the word "Accepted" with its signature across the face of the document.

Inland and Foreign Bills—A Bill of Exchange is used not only in respect of inland dealings but also in respect of international dealings. The former type of bill is called the *Inland Bill* and the latter, *Foreign Bill*. Foreign Bills render an important service to the business community. If metallic coins were to be used for paying foreign creditors two difficulties will arise: Firstly, foreigners will refuse to accept coins on their face value since they are not current in their own country. They will accept them only as bullion. Secondly, much time, labour and money will be wasted in shipping coins from country to country. These difficulties are solved by the use of Bills of Exchange. The London creditor may just draw a bill on his Calcutta debtor and sell it in London to a man who has to make payment to his Bombay creditor. The London creditor, thus, gets his money immediately from a Londoner. The latter sends this bill to his Bombay creditor who presents it to the Calcutta debtor (the drawee) and receives payment from him. Thus accounts are settled without a single pie being shipped from either country. The following diagram shows how accounts are settled.



It is the balance of the mutual indebtedness of the two countries which alone has to be liquidated by shipping metal or coins.

A Bill of Exchange and a Note

A bill of exchange differs from a currency or bank note in significant respects:

<i>Bill of Exchange</i>	<i>Note</i>
(1) It has three parties—drawer, drawee and payee.	(1) It has only two parties—issuer and payee.
(2) It is an order to pay.	(2) It is a promise to pay.
(3) It requires acceptance by the drawee.	(3) It does not require acceptance.
(4) It may be issued by anybody.	(4) It is usually issued by the Government or the Central Bank.
(5) It is not legal tender and is not a part of currency.	(5) It is legal tender and is a part of currency.
(6) It may be demand or time.	(6) It is always demand.
(7) It cannot be re-issued.	(7) It can be re-issued.
(8) It is not subject to special restrictions (except those imposed by the Negotiable Instruments Act).	(8) It is issued under special Act.
(9) It is very important in making foreign payments.	(9) It is not so important.
(10) A bill may be drawn in a set of three.	(10) It is not so drawn.

Cheque

Definition—A cheque is an order drawn on a banker by the depositor requiring the former to pay on demand a definite sum of money to himself or to the

person named therein or to the bearer of the cheque. Legally, it has been defined as a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. In other words, a demand bill of exchange drawn on a banker is known as cheque.

When a depositor opens a current account with a bank, he is given a cheque book. Whenever he desires to withdraw money himself or to make payment to some other person, he fills in the cheque. Some banks have begun to issue cheque books to savings bank depositors also.

Parties to a Cheque—Like a bill of exchange, a cheque has three parties, viz., (1) the drawer, the depositor who writes the cheque, (2) the drawee, the bank on whom the cheque is drawn; and (3) the payee, the person specified in the cheque for receiving payment. Cheques are of three kinds : bearer cheques, order cheques and crossed cheques.

Bearer Cheques—A bearer cheque is made payable to the bearer, i.e., it is payable to the person who presents it to the banker for encashment. The bank is under no liability to ascertain that the payment is made to the right person. If a man finds a bearer cheque lying on a street and gets it encashed by the banker, the latter is not liable for the wrong payment. Bearer cheques do not require endorsement. The following is an example of a bearer cheque :—

No. A5302

Dated, Allahabad, June 1, 1938

JWALA BANK, LTD.

Allahabad

Pay to Dr. R. N. Dubey or bearer Rupees Five Hundred only.

Rs. 500 = 0 = 0.

For Kitab-Mahal, Publisher

S. N. Agarwala,

Manager

Order Cheque—A cheque made payable to a certain person "or order" is called an order cheque. In the case of an order cheque, the bank is liable to ascertain that it is paid to the right person. If the payment is made to a wrong person due to the negligence of the bank, it shall be responsible for wrong payment. An order cheque must also be endorsed at the time of its transferability. Endorsement is effected by signing the name on the back of the cheque. In the absence of an endorsement, the transference of the order cheque will be invalid.

Crossed Cheque—Sometimes two parallel and transverse lines are drawn across the face of the cheque with, or without, the words "A/C" or "& Co." etc. Such a cheque is known as a crossed cheque. A crossed cheque cannot be encashed at the counter of the drawee bank. The bank on whom it is drawn shall pay it only to a bank. When a man receives a crossed cheque, he usually deposits it with his own banker who collects it from the drawee bank. Such cheques are absolutely safe as chances of wrong payment are evidently minimised.

A Cheque and a Bill of Exchange—The following are the points of difference between a cheque and a bill of exchange :—

<i>Cheque</i>	<i>Bill of Exchange</i>
(1) It is always drawn on a banker.	(1) The drawee may not be a banker.
(2) It is not accepted.	(2) It is accepted unless it is a demand bill.
(3) It is always payable on demand	(3) It may be a demand or a time document.
(4) It is used, generally, for internal circulation only.	(4) It is a very important means of settling international indebtedness.
(5) It may be crossed.	(5) It is never crossed.

The drawee is not bound to pay, and will not pay, in case of any irregularity. (6) The drawee who has accepted it is bound to pay it under any circumstances.

The bank is protected against forged endorsement of a cheque drawn on him. (7) The bank which pays a bill containing a forged endorsement cannot debit the acceptor for the amount.

Any delay in the presentment of the cheque to the bank does not free the drawer and endorser from liability, unless the bank fails in the meantime. (8) If the (time) bill is not presented on due date, drawers and endorsers become free from liability.

A Cheque and a Bank Note—The following are points of difference between a cheque and a bank note—

<i>Cheque</i>	<i>Bank Note</i>
It is not legal tender.	(1) It is legal tender.
It is an order to pay a certain sum of money.	(2) It is a promise to pay a certain sum of money.
It may be bearer or order.	(3) It is always bearer.
It is drawn by a depositor.	(4) It is made by issuing authority—the State or the Central Bank.
It may be crossed.	(5) It is not crossed.
Its life is short as it does not inspire confidence in all.	(6) It has long life as it inspires great confidence in all.

Cheques in India—Cheques have many advantages. They constitute a very cheap medium of

exchange; their volume varies directly and automatically with currency requirements of the country; and they have many other merits besides. It is unfortunate that in our country the use of cheques is not well-developed. The following are the means by which the practice of using cheques can be extended in this country: (1) The masses of the country are mostly illiterate and cannot write cheques. Attempts must be made to spread education among them while banks should devise some method of enabling them to draw cheques. (2) At present cheques must usually be written in English. All persons do not know English, which prevents the use of cheques on a large scale. Attempts must be made to persuade or compel banks to make use of vernaculars. (3) Banks should provide facilities for prompt encashment of cheques at the counter. Traders and other customers should be encouraged by banks to use cheques. (4) Joint stock and co-operative banks should allow money to be withdrawn from savings bank accounts by cheques. Cheques should be accepted in payment of land revenue, local rates, and taxes. (5) The Government and local bodies should also make payments through cheques. (6) The Imperial Bank should revise the policy of charging low rates of commission on up-country cheques. (7) Finally, extension of banking facilities is likely to encourage cheque habit.

Bank Draft

A bank draft is a cheque drawn by one bank upon another bank or its own branch situated at a different place, requiring it to pay a certain sum of money to a specified person or to his order or to the bearer. A bank draft may be inland or foreign. Usually persons who have to make payments to distant creditors go to their bank to obtain a bank draft. They have to deposit with the banker the amount to be remitted plus a small commission. Draft is then issued which is sent to the creditor concerned who gets it encashed.

Hundi

Definition—Hundi is the oldest surviving form of

credit instrument in this country. In simple words, a hundi can be defined as a written order, usually unconditional, drawn by one person on another for the payment, on demand or after a specified time, of a certain sum of money, to a person named therein. A hundi is not quite an Indian bill of exchange as the existing text-books often make it out to be⁵. A bill of exchange is always an unconditional order while a hundi is sometimes conditional.

Functions of Hundies—Hundies play a very important part in the financing of the internal trade of this country. It is a convenient form of remittance of money from one place to another. It is also used for getting advances. A merchant in need of funds sometimes draws a hundi on his agent or some other person or firm with whom an arrangement is made beforehand, and gets it discounted at the bank. But the hundi does not occupy the same position in India as the bill of exchange does in England. A hundi does not contain anything to show that it is drawn against commercial goods and, as such, banks do not readily accept it. Usually they require endorsements of well-known bankers on it.

Sub-divisions of Hundies—A hundi may be *darshani*, i. e., payable on demand, or *muddati*, i. e., payable after a specified period. Darshani and Muddati hundies are sub-divided into:—

(i) *Dhanjog Hundi*—Dhanjog hundi is payable to the Dhani or possessor. The bank is not liable if somehow the payment is made to the wrong person.

(ii) *Shahjog Hundi*—Shahjog hundi is payable to 'Shah', i. e., to a respectable person. The bank which pays a Shahjog hundi is responsible to see that the presenter is the proper person to receive the payment. The Shahjog hundi is like a crossed cheque, the only difference being that such a cheque is paid to a third party through a bank while the hundi is paid only to the special Shah.

5. Dr. L. C. Jain, *Indigenous Banking*,

(3) *Firmanjog Hundi*—This is made payable to order, the word *Firman* meaning order.

(4) *Dekhanhar Hundi*—It is payable to bearer.

SPECIMEN OF A HUNDI

Om.

Number 345. *Sidh shree Allahabad shubhsthan shree patri bhai Navin Narain Shri Narain likhi Etah se Sri Niwas Sri Murari ki Ram Ram banchana. Appranch hundi kita nag ek rupia 250 ankan do sau pachas jis ka nime rupia ek sau pachchis ka duna pura athe rakha. The Mahaluxmi Etah Bank Limited pas miti Bhadon sudi nomi se din 60 sath pichche name shahjog Hundi chalan kaldar diya, miti Bhadon sudi 9 samwat 1978.*

Translation

Om.

No. 345

To Messrs. Navin Narain Sri Narain of the pleasant and prosperous city of Allahabad, Sri Niwas Sri Murari send their greetings from Etah. Further, a hundi of Rs. 250, in words Rupees two hundred and fifty, the half of which is one hundred and twenty five, pay the double of this to the Mahaluxmi Etah Bank Limited, from Bhadon sudi 9 after 60 days in current money with Emperor's head after due inquiry. Bhadon sudi 9 samwat 1978.

Explanation—This is a time Shahjog hundi. Messrs. Sri Niwas Sri Murari are the drawers, Messrs. Navin Narain Sri Narain, the drawees, and Mahaluxmi Etah Bank Limited, the payee. The Hundi is written for Rs. 250.

§ 3. BANKS

Definition

Banks perform a large variety of functions in the modern society. As such, the word 'Bank' has been defined in numerous ways according to the aspect, or aspects, specially emphasized by writers. The simplest definition of the word 'Bank' is the one

which emphasizes the essentials of this institution. A bank, as everybody knows, receives deposits from those who want to commit their wealth to safety and earn some interest also; in other words, it *borrow money*. It also *lends money* to the needy. The borrowing and the lending of money are its essential functions. It may, therefore, be defined as an institution which borrows and lends money. As the purchase and sale of the use of money are credit operations, economists usually define banks as *institutions dealing in credit and money*⁶.

Functions and Utility of Banks

The modern bank performs numerous functions which throw light on the variety of the services it renders to the modern civilized society. They have been rightly styled as the "nerve-centre of the modern world." These functions can be conveniently divided into three classes; (1) Primary Functions; (2) General Utility Functions; and (3) Agency Functions.

(1) *Primary Functions*—The primary and essential functions of a bank, as is evident from the definition of the word 'bank', are two: the borrowing and the lending of money. A bank borrows money with one hand in order to lend it with the other; and this essential feature of its business remains the same whether the bank is a vast joint-stock organization, with a wealth of resources and net-work of branches and agencies, or a comparatively small private bank, or "a pioneer bank in a new country, with a stock-in-trade consisting of a tent, a safe, a trestle table, and a revolver."

(a) *The borrowing of money*. Banks borrow money through receiving deposits. Persons having money but faced with the problem of its proper

6. Some authorities on banking give importance to the maintenance of current accounts. Thus Hart says, "A banker is one, who, in the ordinary course of his business, receives money which he repays by honouring cheque of persons from whom, or for whose account, he receives it". (Hart, *Law of Banking*) Some economists maintain that the diversity of modern banking operations in order to satisfy the changing needs of our dynamic society forbids all attempts at an exhaustive definition of the term bank. We should describe the functions of various types of banks rather than define the bank itself. For instance, See Rau, *Elementary Banking*.

investment or safe custody, deposit it with banks and, in many cases, receive interest.

Money may be deposited in a Current Account or a Deposit Account or a Savings Bank Account. In the case of a Current Account, Deposit, money may be withdrawn by cheques whenever necessary and no notice need be given to the bank. Usually no interest is given on current deposits, unless a minimum balance of a considerable sum is maintained. In the case of a *Fixed Deposit Account*, the deposit is made for a fixed period and is not withdrawable before the expiry of that period. An attractive rate of interest is given on such deposits. In the case of a *Savings Bank Account*, money deposited may be withdrawn with certain limitations; for instance, in Post Office Savings Bank Deposits, withdrawals may be made only once a week and if a large sum is to be withdrawn, previous notice to the Post Office is necessary. Such deposits carry a moderate rate of interest.

This function of the bank encourages people to *save* money. When it is known that an easy and convenient means of safe and profitable investment of money in the shape of deposits is available, people who would have otherwise spent all their income or hoard it underground, do not do so. They begin to take pleasure in seeing their Bank Pass Book balance increasing in amount through deposits and interest.

(b) *The lending of money.* The small deposits received by banks together constitute a huge amount. This is lent out by the banks to capable agriculturists, industrialists and business men, who invest it in their ventures to their own profit and to the economic advancement of the country. The tiny streamlets of individual savings flowing into bank vaults are thus made to flow out as rivers to irrigate the fields of agriculturists, to move the wheels of industry and to float the vessels of commerce. The great service rendered by banks in converting huge idle resources into active capital, by acting as a sort of standing brokers between the quiet saving districts and persons and the active employing

districts and persons, is too much to be appreciated. Money is lent to industrialists, agriculturists and traders in various ways. The discounting of bills of exchange and the granting of overdraft on current accounts are two important methods of commercial credit.

(2) *General Utility Functions*—Besides the primary functions mentioned above, the modern bank performs many miscellaneous functions which are of great general utility.

(a) *Issue of notes.* The issue of notes is usually entrusted to a duly constituted Central or Reserve Bank of the country which has the capacity to perform this function more efficiently than the Government. In India the sole right of the note issue is vested in the newly established Reserve Bank of India. In Great Britain, the Bank of England enjoys this privilege.

(b) *Supply of currency.* Modern banks are the means through which, not only paper currency, but all forms of currency are put into circulation. They also discharge the relative duty of withdrawing from circulation light coins and defaced notes.

(c) *Issue of credit instruments.* Banks create credit instruments like bank drafts, cheques, letters of credit, etc., which economise the use of metallic currency, make the transmission of money over long distances convenient and cheap, and remove the want of medium of exchange felt by modern communities, currency alone being inadequate to meet the entire need.

(d) *Foreign exchange business.* In olden days, each country used to have different coins in different parts, and bankers did the useful work of changing one kind of money into the other kinds. This gave them the name of 'money-changers'. This function has now become defunct as each country has begun to maintain a uniform currency throughout its length and breadth. But different countries still possess different currencies, and banks play the important role of purchasing and selling foreign currency,

foreign bills of exchange and other credit instruments in exchange for the currency of the country in which they are situated. They facilitate foreign trade to an appreciable degree.

(e) *Safe custody of valuables.* Banks undertake to keep in safe custody valuables and important documents in specially constructed strong rooms which are sure safeguards against fire and theft. The small payment charged by them for the purpose is nothing in comparison to the utility of the service rendered.

(3) *Agency Functions*—Banks also render many 'agency services' by acting as agents to their customers in various capacities.

(a) They collect and pay cheques, realise dividends and interest and pay subscriptions and insurance premiums in the capacity of special agents to their customers.

(b) Banks conduct stock and share transactions on behalf of their customers.

(c) They act in various other agency capacities such as those of trustees, attorneys and executors.

Kinds of Banks

The financial requirements of the modern community are diverse and various so that different types of banks have been set up for specializing in different kinds of finance. The main kinds of banks are mentioned below :—

1. *Commercial Banks*—They finance the internal trade of a country. They collect the floating capital of the community and finance the temporary needs of commercial transactions.

2. *Exchange Banks*—Their sole concern is to finance the foreign trade of a country.

3. *Industrial Banks*—They finance the industries requiring long-term credit.

4. *Agricultural Banks*—They finance agriculture. As a rule, they provide the long-term finance.

5. *Co-operative Banks*—They are usually started with the object of financing short-term needs of agriculture and industries.

6. *Savings Banks*—They mobilise the small savings of the people in the savings bank accounts.

7. *Indigenous or Private Bankers*—In most of the countries there is a large number of private or individual bankers who have been catering to the various financial requirements of the community as an hereditary occupation.

Banks Lend More Than What They Deposit

An interesting aspect of the banking business is that banks are in a position to make advances much larger than the deposits that they receive. It is a sort of anomaly and often puzzles students.

In order to understand this problem it should first be made clear that the money borrowed from a bank is usually deposited in the same bank by the borrowers, either because the bank insists on it or because there are certain advantages in having a current account deposit. It is this procedure which makes the deposits of a bank so large. Such deposits are known as *credit deposits* as against *cash deposit*, i.e., the deposit of actual cash. Now, banks know on the basis of their past experience that the whole of the money deposited is not withdrawn at any particular time. The maximum possible demand is usually a certain percentage of the total deposits. This percentage roughly comes to 10 per cent. Banks, therefore, keep a 10 per cent "reserve" against deposits and lend the remaining amount. Thus, suppose a cash deposit of Rs. 1,000 is made with a particular bank. It will keep (10 per cent of Rs. 1,000) Rs. 100 as reserve against this deposit and give a loan of Rs. 900. This amount will be deposited by the borrower in the same bank. It will keep (10 per cent of Rs. 900) Rs. 90 as reserve against this deposit and give a fresh loan of Rs. 810. This process will be repeated as long as possible. According to this policy, a bank is in a position to lend roughly ten times more than the cash deposits it receives.

PROFIT AND LOSS ACCOUNT AND BALANCE SHEET OF A BANK

The important accounting documents of a bank are (1) Profit and Loss Account and (2) Balance Sheet.

Profit and Loss Account—A Profit and Loss Account shows the various items of income and expenditure, strikes out the net profit or loss and describes the appropriation thereof. The following is an imaginary Profit and Loss Account of X Y Z Bank, Limited.

*Profit and Loss Account of the X Y Z Bank
Limited for the year ending December 31, 1939.*

Dr.

Cr.

Particulars	Rs.	Particulars	Rs.
To General Expenses	25,000	By Balance	10 000
To Depreciation of Premises	9 000	By Interest and Discount	1,50,000
To Income Tax	3,000	...	...
To Balance	1,23 000	...	...
	1,60 000		1,60,000
To Dividend Paid	1,00 000	By Balance	1,23,000
To Balance	23 000	...	...
	1,23 000		1,23,000

In this account, the left-hand (debit) side records all items of loss and expenditure and the right-hand (credit) side, of gain or income. The balance of Rs. 1,23,000 is the net profit of the year 1939. Its appropriation is shown in the lower half of the Account: Rs. 1,00,000 are paid in the shape of dividends, leaving a balance of Rs. 23,000.

Balance sheet—Balance Sheet is a statement showing the assets and liabilities of a concern, thus giving an idea

of its financial position. *Assets* indicate the properties in the possession of the bank and the money owing to it by others. Assets are shown on the right-hand side of the Balance Sheet. *Liabilities* are the financial obligations of the concern and are shown on the left-hand side of the Balance Sheet. We give below an imaginary bank's Balance Sheet for the sake of illustration.

Balance Sheet of the X Y Z Bank Limited for the year ending December 31, 1939.

Liabilities	Rs.	Assets	Rs.
Authorized Capital: 50 000 shares of Rs. 10 each	5,00,000	Cash in hand and at Bank	3 00 000
Issued Capital 25,000 shares of Rs. 10 each.	2,50,050	Money at call and short notice.	1,00,000
Subscribed Capital 20,000 shares of Rs. 10 each.	2,00,000	Investment in Securities.	10 00,000
Paid up capital 20 000 shares of Rs. 10 each.	2,00,000	Loans and Advances	1,00,000
Reserve Fund	1,90 000	Bills Discounted	1,50 000
Deposit Accounts	13,00,000	Bank Premises	73,000
Interest Account	10,000	...	...
Profit and Loss Account	23,000	...	...
	17,23,000		17,23,000

Liabilities—This Balance Sheet needs explanation. We shall discuss the liabilities first.

1. *Capital*—Capital is the first item. Capital is of various kinds. *Authorised Capital* is the maximum amount which the company is authorised (by its Memorandum) to raise. It is Rs. 5,00,000 in the above B/S. Usually the whole of the authorised capital is not issued for subscription by the public: only a part of it is so issued and it is called *Issued Capital*. The Issued Capital amounts to Rs. 2,50,000

in the above B/S. The share capital which is actually subscribed for by the public is known as *Subscribed Capital*. It is shown at Rs. 2,00,000 in the Balance Sheet under discussion. *Called-up Capital* is the capital which the directors of the bank call upon the subscribers to pay. The *Paid-up Capital* is the capital actually paid by the Shareholders; it is Rs. 2,00,000.

2. *Reserve Fund*—Usually a part of profits is withheld from being distributed as dividend and is transferred to what is called the *Reserve Fund* to be made use of in times of financial embarrassment.

3. *Deposit Accounts* of Rs. 13,00,000 represent the total deposits received by the bank.

4. *Interest Account* shows that the bank has to pay Rs. 10,000 by way of interest.

5. *Profit and Loss Account* shows that the balance of the P. & L. A/C which has been given above.

Assets—Let us now briefly examine the assets side of the Balance Sheet as well.

1. *Cash in Hand and Cash at Bank*—It is too simple to need explanation.

2. *Money at Call and Short Notice*—This is the money lent by the bank on the condition that it will have to be paid whenever called or after the expiry of a short notice given to the effect.

3. *Investments in Securities* of British, Indian Provincial and States Governments etc.,

4. *Loans and Advances.*

5. *Bills Discounted*—The Bank has discounted bills of exchange worth Rs. 1,50,000. It has to receive this amount from the acceptors of the bills on their respective due dates.

6. *Bank Premises, i.e., buildings* of the bank, are valued at Rs. 73,000.

CHAPTER IX

INDIAN BANKING SYSTEM

It may be accepted that a system of banking eminently suited to India's then requirements was in force in that country many centuries before the science of banking became an accomplished fact in England. It is true that the methods of old in force in India were vastly different from the European ideas of banking to-day ... nevertheless.....they admirably acted their part and must be recognised as having rendered immense services to the country as a whole—*W. E. Preston*

INDIAN MONEY MARKET

Money Market

'Money Market'¹ refers to the buyers and sellers of the use of money. In other words, the term signifies the borrowers and lenders of money. Money is usually borrowed by agriculturists, industrialists and traders for productive purposes and by consumers for unproductive purposes, to tide over temporary deficits in their budgets². Money is lent by banks and money-lenders. The borrowers and lenders together constitute the money market.

Indian Money Market

India has a money market but it is small and divided, haphazardly organized and poor in variety, and generally backward to a deplorable extent. Its constituents are—

A. The Indian Banking System : The Lenders—

- (1) The Indigenous Banking System;
- (2) The Modern Banking system; and
- (3) The Reserve Bank of India.

B. The Borrowers

We shall give below a brief description of these constituents. The borrowers, it may be remarked,

1. Students should remember that 'market' does not refer to any particular market place but to the buyers and sellers of a commodity in which they carry on free and unhampered trade.

2. Banks, too, borrow money in the shape of deposits from their depositors

will not be treated separately but will be given incidental consideration along with the discussion of the Indian Banking System.

§ 2. THE INDIGENOUS BANKING SYSTEM³

The Indian Banking System is divided into two systems—(1) *The Indigenous Banking System* which has been handed down to us from our ancestors; and (2) *The Modern Banking System* set up by our Occidental rulers. These two parts have so far remained separate and the problem of removing the gulf between them is one of the most pressing problems of the day.

Introductory—The word 'Indigenous' according to dictionary, means 'native of the place.' As such 'indigenous banking' means *banking business carried on by the natives in the old Indian fashion*. It is now generally admitted that from very early times India possessed an efficient system of indigenous banking. In fact, money-lending can be traced back to 2,000 B. C. and the subsequent history bristles with definite references to the banking business carried on in the days of yore. The Buddhist works, Kautilya's *Arthashastra*, and *Dharma Shastra* make detailed remarks about indigenous banking and show its importance in the economy of the country in those times. Indeed, even today indigenous bankers play a much more important part than the more imposing modern banks. They are spread throughout the length and breadth of the country and are to be found in every village, town and city. They are called by different names: in the mofussil they are known as *sahukars*, *banias* and *mahajans* while in large industrial and commercial centres they are called *shroffs*. The firm of indigenous bankers is usually a family concern and is not organised on joint stock principle.

Functions—(i) The main business of indigenous bankers is to *advance loans* on every kind of security—ornaments, land, promissory notes or even verbal promise. In villages, they finance agriculturists

3 For detailed study See L. C. Jain, *Indigenous Banking in India*, H. Sinha, *Early European Banking in India* B. T. Thakur, *Organisation of Indian Banking*, *Banking Enquiry Committee Reports*, etc.

and petty artisans who rarely have any good security to offer. In such areas, indigenous bankers are almost the only source of credit. Their methods are very simple and free from formalities and suit the illiterate borrowers eminently. In towns, they finance trade and big mills and factories. (2) They also *deal in hundies*. They buy or discount hundies offered by their customers and cash those drawn upon them by their agents or by approved firms. They sell hundies drawn upon their agents or other firms agreeing to this arrangement. (3) Some of them also *receive deposits* but all or most of them do not do so. (4) They generally combine trading with the banking or money-lending business. They deal in cotton, grain, gold etc., while many of them indulge in speculation.

Are They Really Bankers—The indigenous bankers are called 'bankers'; but are they really *bankers*, in the strict sense of the term? A banker is one who borrows money as well as lends it. Indigenous bankers lend money; but only in rare cases do they receive deposits. As such those *indigenous bankers* who do not receive deposits are not 'bankers' but are merely money-lenders. Those who do receive deposits are, of course, true bankers⁴.

Comparison with Modern Banks—The above discussion throws considerable light on the points of difference between indigenous bankers and modern bankers. These points of difference may be tabulated as below :—

Indigenous Bankers

1. Their firm is usually organised as a family concern.

Modern Bankers

1. They are generally incorporated as a joint stock company.

⁴ Indian Banking Enquiry Committee divides 'Indigenous bankers' into *indigenous bankers* and *indigenous money-lenders* from this point of view. This terminology evidently creates certain confusion. In my opinion, if we name the members of this system as '*Indigenous Financiers*' in place of '*Indigenous Bankers*' and divide indigenous financiers into indigenous bankers and indigenous money-lenders, this terminological confusion will be removed.

- | | |
|--|---|
| 2. Only a few of them receive deposits. | 2. The receipt of deposits is their important function. In fact, their capital comes not so much from its proprietors or shareholders as from their depositors. |
| 3. They frequently combine trading with banking. | 3. They do not combine any other business with the banking business. |
| 4. They do not issue paper currency. | 4. The Central or Reserve Bank is given the sole right of note issue. |
| 5. Major portion of their funds is lent without adequate security; as such, they undertake great risk. | 5. Loans are granted only against substantial security so as to minimize risk. |
| 6. They usually finance petty agriculturists, small artisans and short-distance trade. | 6. They finance big concerns and long distance trade. The financing of foreign trade is almost exclusively their preserve. |
| 7. Major portion of their work is done in villages. | 7. Most of them are situated in big industrial cities. |
| 8. Their numerical strength is immense and their financing operations, very extensive. | 8. They are not so numerous nor is their business so extensive. |
| 9. They have few branches, if any. | 9. They have many branches. |

Their Defects—Indigenous banking system has certain grave defects. Indigenous bankers, money-

lenders in particular, charge ¹usurious rates of interest and exploit the borrowers according to the urgency of their demand. *Pathans* and *kabulies* charge very high rates, ranging up to 300 or 400 per cent. or even more. In addition to it, they adopt ²many sharp practices which arouse much opposition. ³The obtaining of thumb impression of the borrower and filling in any amount afterwards, the levy of inequitable charges like *khatakhelai* or *nazrana*, and forced labour, virtually reduce the borrowers to the position of serfs. There is, indeed, a class of economists who sincerely believe that the indigenous banking system should be abolished completely.

Their Merits—This is, of course, an extreme view and overlooks the merits of the system. Indigenous bankers adopt ¹simple methods which illiterate borrowers readily understand. ²Moreover, they are very informal and do not hesitate to give loans on poor or no security at all and at any time. ³A more important fact is that they are almost the only oasis of thrift in the vast desert of extravagance and destitution and the only source from which credit can be had. If this system is abolished, and no better system replaces it simultaneously, nothing but injury will be inflicted on poor borrowers. The money-lender certainly drives a hard bargain but the existence of great risk in lending money on little or no security forces him to do so. "To censure him is to censure the imperfections of mankind. We should rather blame the system than the man it has moulded."

Suggestions for Improvement—The best that can be done under the circumstances is to continue the system after curing it of its defects. ¹Indigenous bankers should be encouraged, in various ways, to receive deposits. ²They should be persuaded to charge reasonable rates of interest. ³Compulsory legislation of a moderate character and the ⁴establishment of co-operative credit societies can be relied upon to tone down the existing high rates of interest. Attempts must also be made to bring this part of ⁵Indian money market into close contact with the modern banking system. Other suggestions are:

6(1) the amalgamation of indigenous bankers into joint stock banks; 7(2) the formation of a co-operative bank of indigenous bankers, which should, *inter alia*, discount *hundies* of the members and rediscount the same with the Reserve Bank of India; 8(3) the adoption of bill brokerage as an integral part of the indigenous bankers' business.

§ 3. MODERN BANKING SYSTEM

With the advent of the Europeans in India, modern banks began to be set up on the western lines. And to-day we have got a fine system of modern banks, though it leaves much to be desired. Its important limbs are :—

1. Commercial Banks.
2. The Imperial Bank of India.
3. Exchange Banks.
4. Industrial Banks.
5. Land Mortgage Banks.
6. Co-operative Banks.
7. Savings Banks.

8. The Reserve Bank of India is, by virtue of its being the 'apex bank', given a separate treatment in the following section.

Their Organisation—Most of these banks are organised on the *joint stock principle*: they are joint stock companies for carrying on banking business. For instance, commercial banks, exchange banks and industrial banks are generally joint stock companies. The Reserve Bank of India and the Imperial Bank of India are also joint stock banks but they have been incorporated under special Acts. Co-operative Banks are organised on the *co-operative principle*. Savings banks are a department of the joint stock banks or of the Post Office which is a Government institution⁵. Sometimes students get the wrong impre-

5. writers on the subject lump together all types of bank under the title "Indian Joint Stock Banks" This treatment, not being sufficiently analytical, sometimes gives the wrong impression that by Indian joint stock banks is meant Commercial banks (as most of the Indian Joint Stock Banks are Commercial banks. I have, therefore, slightly varied the mode of treatment.

ession that a joint stock bank means a commercial bank because most of the joint stock banks in India are commercial banks. But this is an altogether mistaken notion.

1. Commercial Banks

Their Nature—Most of the modern Banks in India are Commercial Banks. As their name implies, they finance the internal trade of the country and give short-term loans for the purpose. They provide the working capital, so to say. On the basis of the cash resources and the deposits that they possess, they raise a huge structure of short-dated credit. Their deposits being mostly demand obligations, they take precautions against getting their funds enmeshed in long term loans: in order to be able to meet the demands of depositors, they have to keep their funds 'liquid'.

Their Position in India—The Indian Commercial Banks, other than the Allahabad Bank and the Oudh Commercial Bank, were all established in recent years. The important commercial banks of the country are the Imperial Bank of India, the Central Bank of India, the Punjab National Bank and the Allahabad Bank. They are distributed in big cities like Calcutta, Bombay, Cawnpore etc., and have not yet penetrated into the interior. Some economists believe that we should not increase the number of the banking offices in the country for the time being but should address ourselves to the problem of consolidation of the existing banks. Others, however, think that since the vast tracts of the country are still unserved by efficient banks, the establishment of new banks need not be discouraged.

Defects and Remedies—Our commercial banks suffer from many disadvantages which need remedy. They do not give clean advances on the personal securities of borrowers. In practice, clean advances on personal security of an individual of undoubted means and character, turn out to be just as safe and satisfactory as any other. Again, they lack the systematic collection of credit information about their custo-

6. Liquidity refers to the ready convertibility into cash.

mers, which should be evolved: Efforts should also be made to *popularise the use of bills* by providing discount facilities. They should try to encourage the use of cheques through various means discussed in the preceding chapter.

2 The Imperial Bank of India

The Imperial Bank of India, formed in January, 1921, under the Imperial Bank of India Act, is at present the most powerful commercial bank of the country. It has had a romantic career. It was formed in 1921 as a shareholders' bank by the amalgamation of the three Presidency Banks of Calcutta, Bombay and Madras and was expected to discharge the functions of a Central or Reserve Bank. The Act, as such, set up an elaborate system of its control and management which are entrusted to a Central Board of Governors with three local Boards at Calcutta, Bombay and Madras. Important restrictions were also originally placed on its functions. Thus it was prohibited from lending money for more than six months and from financing foreign trade. Its chief functions were the following :—

(1) To act as a banker to the Governmental bodies.

(2) To act as a banker to other banks.

(3) To advance money on the security of stocks, Government securities, debentures, goods etc., (with certain limitations).

(4) To draw, accept, discount, buy and sell bills of exchange and other negotiable securities.

(5) To receive deposits and securities for safe custody.

(6) To transact various other miscellaneous banking functions.

The Act put the Bank under an obligation to open 100 branches within a period of 'five years from its inception, an obligation which was duly discharged.

Due to the defective provisions of the Act and the spirit with which it was administered, the working of the Imperial Bank did not come up to the expected level. It was given certain privileges which are usual in the case of a Central Bank alone. But, curiously enough, it was not effectively debarred from entering into competition with other banks. The consequence was that it made use of its special privileges to obtain unfair competitive advantages over other banks of the country. It was neither a full-fledged Central Bank nor an independent commercial bank, but a hybrid mixture of both; and was severely criticized in both these forms.

The mistake was realised in course of time. The correction was made in 1935 when the Reserve Bank of India was set up to act as the Central Bank of the country. The Imperial Bank ceased to be the Central or Reserve Bank from that date. It, however, entered into an agreement with the Reserve Bank of India by which it became the sole agent of the Reserve Bank. The Imperial Bank Act was amended. The restrictive provisions, that the Bank cannot transact foreign exchange business and that it cannot lend for more than 6 months, etc., have been relaxed. It is expected that the Bank shall render greater services to the country under its amended constitution than that it has done in the past.

3. Exchange Banks

Just as commercial banks finance the internal trade of the country, similarly exchange banks finance its foreign trade.

The following is their business :—

(1) They realise the import bills on the maturity dates.

(2) They sell drafts and Telegraphic Transfers payable in foreign countries.

(3) They purchase drafts and Telegraphic Transfer etc., at foreign centres payable in the centres where they conduct their operations.

(4) They import gold and silver as well as foreign currency.

The most important point regarding exchange banks is that *all of them are foreign banks*⁷. There is not a single *Indian* exchange bank. Attempts⁸ had been made in the past to start an Indian exchange bank but they were nipped in the bud by the powerful foreign exchange banks. The Central Bank of India recently took the lead in this direction and started the Central (Exchange) Bank of India in London but it had to close down the venture in the teeth of crushing competition of the privileged foreign banks.

The absence of Indian foreign banks is not merely an academic patriotic insult to India; it also creates many practical difficulties. Complaints have been made that these banks are unduly harsh on Indian business men and show favour to the traders of their own country in various matters, small and big. They do not supply satisfactory references about Indian merchants to foreigners and literally force Indian merchants to insure goods with foreign insurance companies and to ship goods in foreign ships. Of late, they have also begun to receive deposits in India by opening branches in the interior and to utilise the funds as they please, not infrequently against the economic interests of this country. It is high time that such sharp practices should be stopped and protection afforded to Indian institutions of this character.

4. Industrial Banks

Industrial banks are meant to finance industrialists for long periods. Just as commercial banks provide working capital, industrial banks provide *fixed capital* to industrialists. Since they give long term loans, they persuade people to entrust them with money in the shape of fixed deposits by offering attractive rates of interest and by other methods. They also aid industrialists in raising capital from the public by under-

7. The important exchange banks working in India are the Chartered Bank of India, Australia and China, P. & O Banking Corporation, Yokohama Special Bank, etc.

writing the sale of their shares and by selling stocks and bonds. They are evidently very useful institutions, particularly to a country like ours, which is in urgent need of rapid industrialisation. But we, unfortunately, possess very few industrial banks. The Swadeshi Movement led to the establishment of many industrial banks but most of them had to close their doors owing to the lack of capital at the critical stage; while the Punjab banks, which attempted industrial financing with short term deposits, came to grief. Attempts must be made afresh to start such banks on sound lines.

5. Land Mortgage Banks

Land mortgage banks are meant to give long term loans to agriculturists mainly for effecting permanent improvements (i.e., to provide fixed agricultural capital) against the mortgage of land⁸. Their function in agricultural finance corresponds with the function of industrial banks in industrial finance. There are very few land mortgage banks in India. Most of the existing banks have been incorporated under the Co-operative Societies Act. There is an urgent need for more banks of this type.

6. Co-operative Credit Institutions

Co-operative banks and credit societies are the societies established under the Co-operative Societies Act for providing credit to their members. Generally, they give short-term loans to agriculturists and artisans. Co-operative credit institutions fall under three classes:

1. Primary Societies.
2. Central Banks; and
3. Provincial Banks.

Primary Societies are spread throughout the length and breadth of the country and come in direct contact with poor artisans and cultivators whom they finance. They are associations of borrowers and non-

⁸ They also give loans for the redemption of past debts.

borrowers of a particular locality, and the members generally have unlimited liability so that they may be very vigilant in making advances. They receive funds in the shape of share capital, deposits and entrance fees. The deposits made by the Co-operative Central Banks, with which they are affiliated, are also important. Loans are made to the members alone.

Co-operative Central Banks are district institutions, each district having a Central Bank. They unify and direct the Primary Credit Societies affiliated with them and give them financial assistance. Their sources of funds are their own capital, deposits from the public and the funds given by Provincial Co-operative Banks.

Provincial Banks. All the Central Banks of a province are affiliated with the Provincial Bank of that province. The Provincial Banks are thus federations of Central Banks. There is great need of an *All India Co-operative Bank* to federate the activities of the Provincial Banks, no such institution having been established so far.

The co-operative credit movement has not yet shown creditable results on any extensive scale, though it has not been entirely barren of good fruits. Co-operative credit institutions provide credit at low rates of interest thus enabling the poor to effect a saving in the interest charges. It is stated that co-operative credit societies have effected an yearly saving of about one crore of rupees for the agricultural and artisan classes in this way. Not only this; the co-operative credit system provides some control on credit and restricts debts and is distinctly superior to the money-lenders' demoralizing system of dangerously facile credit. In fact, in many cases, co-operation has efficiently competed with indigenous bankers and has compelled them to reduce the rates of interests. Even in the matter of debt redemption, something has certainly been achieved, particularly through the formation of land mortgage banks on co-operative lines. In the words of Mr. Darling, the co-operative movement is a new form of communal life to protect the peasant from

within and without his gates, in the place of the old communal life of village which prevented the cultivator from being exploited. Finally, the movement has popularized banking habit and has converted considerable idle resources and hoards into active capital. The movement certainly suffers from many defects but it is hoped that they will be removed in course of time.

7. Savings Banks

Savings banks are meant to mobilize the small savings of the people on attractive and easy terms, and to use the funds thus collected in profitable channels. Savings banks in India are of two kinds. Some of them are organised as departments of the modern commercial banks while others are maintained by Post Offices. As the latter are Government institutions and inspire more confidence and security, besides being more wide-spread, they are much more important than the former. Withdrawals are generally allowed by them once a week. The rate of interest is usually low. Some banks permit the savings bank accounts to be operated with cheques.

§ 4 THE RESERVE BANK OF INDIA

Objects of a Reserve or Central Bank

The control and regulation of credit and currency with a view to stabilize prices as far as possible, is a problem of fundamental significance. If the supply of credit and currency falls short of the demand for them, prices may fall and depression may set in. On the other hand, if the supply exceeds the demand, prices may rise and an artificial 'boom' may be precipitated, resulting in incalculable loss when the 'bubble' is 'pricked'. An abnormal fluctuation in price level, moreover, upsets the economic relationship subsisting between various classes of people in the society. The control and regulation of credit is, as such, an important function which is usually entrusted to an 'apex bank', called the Central Bank or the Reserve Bank. The Bank is invariably the banker of the Government and of other banks in the country. It also performs many subsidiary functions like the development of discount market, the protection of the

banking system of the country, the popularization of the use of cheques, etc.

History of the Reserve Bank of India

The first day of April, 1935 is of profound importance in the economic history of our country as the Reserve Bank of India commenced its work on that date. The idea of establishing a Central Bank was mooted as early as 1836 and received further thought on several occasions thereafter. But nothing substantial was achieved, till 1921 when the Imperial Bank of India was constituted with the hope that it would work as the Central Bank of the country. It was, in fact, a hybrid institution having certain privileges usual only in the case of a Central Bank, as well as the right to compete freely with other banks in the ordinary banking business. The consequence was that it used its special privileges to crush other banks and thus defeated the very objective for which it was set up. The want of a Reserve Bank continued to be felt. A bill for the formation of a Reserve Bank was piloted by the Finance Member in the Central Assembly in 1927 but was turned down by the members on the question of its ownership. It was, at last, in 1934 that the Reserve Bank of India Act was passed and the Reserve Bank was set up in 1935.

Its Capital and Management

The share capital of the Reserve Bank of India is five crores of rupees, divided in shares of rupees one hundred each, fully paid up. The whole of India has been divided into five areas and a definite share capital has been assigned to each of them, to be subscribed by the inhabitants of that area.

The general superintendence and direction of the business of the Bank is entrusted to a Central Board of Directors. The Board is to consist of:

- (1) One Governor and two Deputy-Governors, appointed by the Governor General in Council.
- (2) Four Directors nominated by the Governor General in Council.
- (3) One Government official nominated by the Governor General in Council.

(4) Eight Directors elected by the shareholders.

Evidently the Government has tried to assert itself too much in the management of the Bank, which may not be compatible with independent actions sanctioned by sound monetary policy.

Its Functions

The functions of the Reserve Bank may be discussed under (A) Central Banking Functions; (B) General Banking Functions; and (C) Restrictions on its business.

(A) *Central Banking Functions*—Like all other Central Banks, the Reserve Bank of India performs the following central banking functions:

(1) It acts as a *banker to the Government*. The Reserve Bank Act requires it to accept money for various Government bodies and make payments up to the amount standing to the credit of their respective accounts; and carry out their exchange, remittance and other banking operations, including the management of the public debt. *Issue of loans on condition of security*

(2) It is a *bankers' bank*. Other banks of the country are required to maintain with it certain cash reserve and evidently the Bank is expected to help them in times of financial stringency.

(3) *It issues paper currency*. The sole right to issue bank notes in British India is vested in the Reserve Bank. It now conducts the issue of bank notes in an Issue Department which is kept wholly separate from the Banking Department. *Assets - mainly of Govt.*

(4) The Bank is also charged to *maintain the rupee-sterling ratio* nearabout 1s. 6d. and, for this purpose, is required to sell to, or to buy from, any person sterling for immediate delivery in London, with certain limitations.

(B) *General Banking Functions*—The Bank is authorized to transact the following commercial business:

(1) The acceptance of money on deposit without interest.

(2) The purchase, sale and rediscount of bills of exchange and promissory notes with certain restrictions.

(3) The making of loans and advances for not more than 90 days against the security of stocks, gold, bills, etc.

(4) The purchase from, and sale to, Scheduled Banks of sterling (in amounts of not less than the equivalent of Rs. 1 lac).

(5) The making of advances to local Government for not more than 3 months.

(6) The purchase and sale of Government securities of the United Kingdom maturing within ten years from the date of purchase and those of the Government of India, Local Governments, Local authorities and certain specified Indian States.

(C) *Forbidden Business*—The Bank is not allowed to engage in trade in the ordinary course of business. It is also debarred from advancing money on the mortgage of immoveable property. It cannot draw or accept bills payable otherwise than on demand. Nor is it permitted to allow interest on deposits. These restrictions are placed to keep it financially sound and to check it from competing with other banks of the country.

Agricultural Credit Department

The Bank, under the Act, has created an Agricultural Credit Department with the object of studying the problem of rural credit, improving the machinery for dealing with agricultural finance and effecting a closer connection between indigenous bankers and modern banking system. But so far very little has been done in this direction.

CHAPTER X

RURAL INDEBTEDNESS

One peculiar feature of agricultural indebtedness is that it is in most cases a mark of distress, whereas in the case of other industries, borrowed finance is a normal feature. As the loans are mostly for unproductive purposes, the pressure of indebtedness falls very heavily on the *rayat*—*Bengal Provincial Banking Enquiry Committee Report*.

The question of rural indebtedness is one of the most important economic problems of our country. The prosperity of the country depends fundamentally upon agriculture, for most of its inhabitants are engaged in this occupation. But agriculture is held up from making progress due to the heavy weight of indebtedness. An effective solution of the problem of rural indebtedness is the first step of our economic progress.

Extent of Rural Indebtedness

The total rural indebtedness of India has been estimated from time to time. The Central Banking Enquiry Committee, 1931, puts the figure at Rs. 900 crores as a rough estimate. Since then much water has flowed down the Ganges and Indian agriculture has passed through the ordeal of the economic depression of 1929, which must have increased this indebtedness appreciably. The present figure may be moderately put at Rs. 1,000 crores¹.

1. The provincial distribution of this indebtedness is as follows :—

			Rs.	Crores
Bihar and Orissa	...	...	155	"
Madras	...	...	150	"
Punjab	...	...	135	"
United Provinces	...	...	124	"
Bengal	...	...	100	"
Bombay	...	...	81	"
Burma	...	...	50.60	"
Central Provinces	...	...	36	"
Assam	...	...	22	"
Central Areas	...	...	18	"
Coorg	...	..	35.55	"

(Vide *Central Banking Enquiry Committee Report*, para 77).

The Causes of Rural Indebtedness

The principal causes of the colossal indebtedness are the following :—

1. *Ancestral Debt*—The most important and common reason is the past indebtedness². Children born in debt are found making every feasible effort to pay the debt of their fathers and fore-fathers. They are probably ignorant of the law that the debts of the deceased pass on to the heir only to the extent of the property inherited by the latter; and if no property is inherited, no liability to pay the debt of the deceased, exists. Even if this knowledge is presumed, the force of social custom and tradition is so compelling as to make them regard the payment of ancestral debt a "pious obligation".

2. *Pressure of Population on Land*—In addition to the ancestral debt that cultivators inherit, they themselves incur financial liabilities for a variety of reasons. An important reason is that income from agriculture is usually insufficient to maintain them and their family. One of the reasons of this state of affairs is the excessive pressure of population on land: the number of people depending upon agriculture for their livelihood is too great to give them living incomes. Consequently they have to borrow from *mahajans* to keep themselves alive.

3. *Subdivision and Fragmentation of Holdings*—Another reason why agriculture is not sufficiently remunerative is the smallness and scatteredness of holdings, which make farming 'uneconomic' and borrowing, inevitable.

4. *Poor Physique of the Cultivator*—Moreover, the cultivator has a weak constitution and is, therefore, inefficient. At certain seasons of real work, he falls a prey to various major and minor diseases and becomes weaker still. His contribution to production is, as such, much less than what it could be.

2. This was the opinion of the Deccan Riots Commission 1875 and the Central Banking Enquiry Committee, 1931.

5. *Floods, Famines, Diseases and Other Calamities*—Indian agriculture is subject to a large number of calamities like floods, shortage of rains, locusts, pests, and diseases, etc. They inflict economic injury on the cultivator in two forms. Firstly, his harvests are damaged and often show poor results. It has been found that in a cycle of five years, one year is good, one bad and three indifferent. Secondly, lack of fodder and diseases like rinderpest take a heavy toll of the cattle of the cultivator. Cattle constitute the most important and costly capital of the cultivator and their loss causes considerable financial embarrassment to him. In either case, he has to go to his *mahajan* who exploits him according to his sweet will.

6. *Extravagance of the Cultivator*—To the agriculturist's extravagant expenditure upon marriage and domestic ceremonies is attributed a fair part of agricultural indebtedness. But many Provincial Banking Enquiry Committees think that the picture of extravagance is generally overdrawn.

7. *Litigation*—Indian cultivators are very fond of litigation. They show an attachment not only to civil suits but also to criminal suits of diverse character. Litigation is certainly responsible for their indebtedness but it is decreasing in importance.

8. *Land Revenue Policy*—Some economists believe that the land revenue realized from cultivators is so heavy and so rigidly collected that they cannot pay it in time without invoking the aid of money-lenders. R. C. Dutt first propounded this view and many thinkers agree with him even now.

9. *Inefficient Rural Credit Organisation*—The present mechanism for supplying credit to cultivators is full of many defects and contributes its own quota to the rural indebtedness. The only source from which loans can at present be had is the house of the village *mahajan* who, besides following many sharp practices and unjustly magnifying the loan, charges usurious rates of interest, which increase the original debt many times over.

10. *Changed Position of Cultivators*—The establishment of the British rule let loose many economic forces like the extension of trade and increase in transport facilities, which pushed up the prices of agricultural land. The value of the security (land) having thus enhanced, the borrowing capacity of the cultivator also went up. He was not slow to take advantage of it and borrowed freely for all sorts of purposes, productive and unproductive, often beyond his capacity to pay it back.

The Attendant Evils

To this state of indebtedness are attributed many of the evils to which the peasant is now subject. Indebtedness has led ultimately to the transfers of land from the agriculturists to non-agricultural money-lenders resulting in the creation of a landless proletariat with a reduced economic status. Moreover, the terms on which loans are given often require the borrowers to sell their produce to, or through, the money-lenders. Sometimes even the price of the produce to be sold is fixed beforehand. It need not be said that the money-lenders give as low a price as they can. Finally, money-lenders impose such unjust charges and exact such services that borrowers is virtually reduced to the level of serfs. These practices are, fortunately, on a decline.

Analysis of the Problem and Remedies

The problem of rural indebtedness can be split up into two parts: (1) The problem of the standing debt, and (2) the problem of the new debt.

(1) The standing debt is mostly ancestral. This debt goes on accumulating at compound rates of interest so rapidly that it soon multiples itself several times; and cultivators lose all hopes of being free from its burden. This standing debt must be redeemed. Some useful work is being done in this connection by land mortgage banks organised on co-operative principle. Further establishment of these banks, on co-operative or joint stock principle, should be encour-

raged. Land mortgage banks, however, give loans at low rates of interest for redeeming standing indebtedness only *against the security of land*; and those who cannot offer this security have no way of getting rid of their standing debt. The problem must be solved earnestly and effectively on the lines suggested by the Banking Enquiry Committees, Royal Commission on Agriculture, etc.

(2) The problem of current debt must also be solved. The present sources of the supply of credit are very defective and lead to further indebtedness in a never-ending fashion. Efforts must be made to remove the defects of the existing mechanism. Much can be done by starting co-operative credit societies. The establishment of branches of modern banks in the interior can also be a source of much help. Something has already been done along these lines and the results, though not extensive, show signs of hope.

Government Legislation

The problem has been tackled through the legislation of various Acts as well. In the 19th Century, two important Acts were passed: (1) The Land Improvement Loans Act, according to which cultivators could obtain loans from the Government at low rates of interest for productive purposes, e.g., construction of field embankments, purchase of better appliances, etc. (2) The Agricultural Loans Act, according to which loans could be had from the Government for meeting current requirements. The *taqavi* loans, as they are called, could not be very popular because of the undue red-tapism with which they have been administered. In 1900 the Punjab Alienation Act was passed to check the transfer of land from agriculturists to non-agriculturists but it simply created a new class of agriculturists money-lenders and did not improve the matters. Various Provincial Governments have enacted several laws. For instance, the U. P. Government have passed the Agriculturists Relief Act, the Encumbered Estates Act, the Usurious Loans Act, etc. But the problem has not yet come under control.

CHAPTER XI

CO-OPERATION IN INDIA

Co-operation is a special form of economic organisation in which the people work together for definite business purposes under certain definite business rules. The root of the co-operative idea is a relation between business and ethics which is greater than the necessary commercial honesty of our present industrial system—*Gordon and O'Brien*.

§ 1. INTRODUCTORY

Meaning of Co-Operation

Co-operation is a voluntary organisation of persons who associate on equal terms for the satisfaction of their common economic needs. To co-operate literally means to work together; but co-operation in Economics, implies that the association is voluntary, that the members have equal standing and that the object is the satisfaction of some economic need. The fundamental object of co-operation is the elimination of the middleman of all kinds and the abandonment of competition in distribution and production.

Fields of its Application

Co-operation has a wide field of application. In fact, wherever middlemen exist and wherever they can be possibly and profitably eliminated, co-operation can be applied with advantage. Specifically, co-operation is of the following kinds. :—

1. *Consumers' Co-operation*—The object of consumers' co-operation is to enable consumers to purchase the articles of their consumption as cheap as possible. The co-operative society, in this case, purchases articles at wholesale rates and sells them cheaply to the members. Any profits made during the year, after meeting all expenses, are divided among the members in proportion to the purchases made by them. Shopkeepers are thus eliminated.

2. *Productive Co-operation*—It is an association for producing certain goods. The members themselves

are the labourers and work through an elected committee. The profits made during the year are divided among the members. This form of co-operation eliminates organisers and entrepreneurs.

3. *Credit Co-operation*—It is meant to meet the credit requirements of the members on the basis of the credit and resources of all of them collectively. Since all the members incur personal liability, the credit of the group is thorough, and consequently money can be borrowed on low rates of interest. Credit co-operation eliminates money-lenders. Credit co-operation is the most popular form of co-operation in India.

4. *Miscellaneous Co-operation*—Then there are a host of other forms of co-operation, e.g., sales co-operation, housing co-operation, insurance co-operation, etc.

Schulze-Delitzsch and Raiffeisen

Germany and Denmark are the two countries in the world in which co-operation has made outstanding progress. The idea of co-operation originated in Germany during the last century, when German agriculturists and artisans were helpless victims of money-lending Shylocks. Their pitiable state made a deep impression on Messrs. Schulze-Delitzsch and Raiffeisen who tried to improve the matters by starting co-operative societies. The former started urban co-operative credit societies to help petty traders and artisans and the latter, rural co-operative credit societies to assist small cultivators. Our credit societies have been modelled after Schulze-Delitzsch and Raiffeisen types. We should, therefore, know the important features of each of them.

In a Raiffeisen society, the area of operation is limited. Generally shares are not issued; it is only rare that shares of very small value, within the reach of everybody's pocket and free from the danger of dividend-hunting, are allowed to be issued. Members have unlimited liability so that they may proceed with maximum vigilance and the credit of the society may be excellent. Loans are given only to the mem-

bers and for productive purposes. ⁴ Loans are granted for relatively long periods and facility for repayment by easy instalments is provided.⁷ Profits are not divided but are credited to a permanent and inalienable reserve fund. The management is honorary and democratic. *Limited area of operation, lack of share capital, unlimited liability, non-issue of loans to non-members and for unproductive purposes, indivisibility of profits and honorary management* are then the chief features of the Raiffeisen Society.

In a Schulze-Delitzsch society, the area of operation is wide. It also possesses a share capital. The liability of the members is limited. The credit is provided only for short terms. Profits are divided among the shareholders, only a part being transferred to the Reserve Fund. The management is paid. *A wide area of operation, existence of capital, limited liability, short term loans, divisibility of profits and paid management* are the essential features of the Schulze-Delitzsch society.

§ 2 HISTORY OF CO-OPERATION IN INDIA

Early Attempts

Co-operation was officially set up in India in 1904. Attempts were made to establish co-operative societies in India even before that year but they were either shelved or met with poor success. All these attempts, it may be remarked, were made to attack the problem of *rural credit*. The first suggestion in this connection came from Sir William Wedderburn and Mr. Justice Ranade whose scheme of agricultural banks, though accepted by Lord Ripon, was turned down by the Secretary of State for India. Again in 1892, Sir Fredrick Nicholson submitted his "Report on Land and Agricultural Banks" to the Government of Madras which he summarized in two notable words, "Find Raiffeisen". He recommended the establishment of rural co-operative credit societies of the Raiffeisen type. But the Government took no action on his Report thinking that the problem of rural credit was not important in Madras. Mr. Dupernex of the United Provinces Civil Service continued the

discussion initiated by Sir Fredrick and published his well-known book 'Peoples Bank for Northern India'. Some societies were also started in the United Provinces, Bengal and the Punjab. But as these attempts were sporadic and no facilities were provided for the growth of the movement, its progress was little. In 1901 the Government appointed a Committee to consider the question of the establishment of Agricultural Banks in India and the report of this Committee resulted in the enactment of the Co-operative Credit Societies Act of 1904.

The Co-operative Societies Act of 1904

The co-operative movement was launched in India on the 25th March 1904. The Act of 1904 made provisions for the formation of credit societies only, partly because the problem of credit was one of the most pressing problems and also because the principles of co-operation could be easily learnt in the simple field of credit societies to be applied to other difficult fields later on, though the Central Banking Enquiry Committee assert that the restrictive scope of the Act of 1904 was just "a slip". Special emphasis was laid on rural, rather than on urban, credit.

According to the provisions of the Act, any ten persons from the same village or town, or of the same tribe or caste, could apply to form themselves into a co-operative credit society. If the four-fifths members were agriculturists, the society was a Rural Co-operative Credit Society and was to be organised on the lines of the Raiffeisen Society. All other Societies were named as the Urban Co-operative Credit Societies and were to be modelled after the Schulze-Delitzsch type.

The members of the rural society were to have unlimited liability and all its profits were to be carried to a permanent Reserve Fund. The urban society was allowed to work on the principle of limited liability, to divide $\frac{4}{5}$ th profits among the members carrying only $\frac{1}{5}$ th to the Reserve Fund. The size of the share capital, if raised at all, was restricted. The societies were expected to raise the working capital from en-

trance fees, deposits from the members, shares and loans from outside sources. Loans could be given only to members. The Government reserved the power of compulsory inspection, audit and dissolution.

The Co-operative Societies Act, 1912

The progress of the movement subsequent to the enactment of the 1904 Act was remarkable. The movement soon outgrew the scope of the Act and another Act was passed in 1912. This Act remedied the defects of its predecessor, authorized the registration of societies for purposes other than credit, and substituted a scientific classification of societies based on the nature of the liability, for the arbitrary one into rural and urban. It also recognised (i) Unions, consisting of primary societies for mutual control and audit, (ii) *Central Banks*, composed of societies and individuals, and (iii) *Provincial Banks*, made up of individuals. It is noteworthy that inspite of the removal of the limitations imposed by the original Act, and the legal creation of several forms of non-credit societies, the preponderating element in Indian co-operation is still credit.

The MacLagan Committee and After

The new Act had a stimulating effect on the movement in India. In 1914, the *MacLagan Committee on Co-operation* was appointed and the movement entered on its third stage of development after the publication of the classic report of this Committee in 1915. The Report led to the re-organisation and overhauling of the administration of co-operative societies. All the societies which failed to reach the ideal of co-operation were eliminated. Punctuality in repayment was insisted upon. The non-official share in the movement began to increase.

Government of India Act, 1919

In 1919 the Government of India Act was passed and co-operation became a provincial subject to the Transferred Departments. The movement thus entered on the fourth stage of its development since it now began to be administered by the ministers of the

Provincial Governments. Much interest began to be evinced in the subject and immediately there was a large addition to the number of societies all over India.

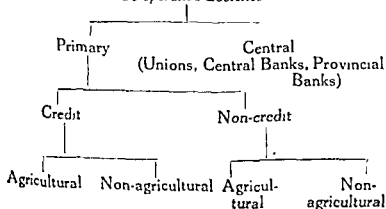
Since then much improvement has taken place. An important line of development has been the appointment of Co-operative Enquiry Committees by various provinces. A Committee was appointed in Central Provinces in 1922 and Behar and Orissa followed suit in 1923. A few years later, the Okden Committee conducted a similar enquiry in the United Provinces; the Townsend Committee in Madras; and the Calvert Committee in Burma. Such enquiries have led to a consolidation and rectification of the co-operative societies. Many provinces have legislated new co-operative laws. Much emphasis has also been laid on non-credit co-operation. In 1926 the *Royal Commission on Agriculture* and in 1931 the *Indian Banking Enquiry Committee* submitted valuable reports and their recommendations have led to a tightening up of supervision, an extension of land mortgage banking and efforts to meet the growth of overdue loans. "The seed thus sown has grown to-day in the course of 30 years into a fine tree with twigs and branches, spread out in many directions".

§ 3. THE PRESENT POSITION

The Co-operative Structure

The following classification shows the present-day structure of co-operative societies in India.

Co-operative Societies



The following table gives the relevant statistics :—

Number of societies in British India and Indian States for 1936-37¹

	British India	Indian States	Total
(1) Central	506	116	622
(2) Supervising and Guaranteeing Unions ...	679	31	710
(3) Agricultural ...	81805	14404	96209
(4) Non-Agricultural ...	11322	2104	13426
Total ..	94,312	16,655	1,10,967

Co-operative Credit Societies

A. Agricultural—Co-operative Credit Societies are agricultural as well as non-agricultural. We have discussed the structure and present position of Agricultural Co-operative Credit Societies in the preceding chapter. We have shown that the foundation of the movement is constituted by the *Primary Societies* which we deal with below in detail :—

(1) *Size of the Society.* Any ten persons can organise a rural credit society. The number of members should not be very large as it deteriorates efficiency.

(2) *Area of Operation.* The area of operation of a society should not be wide. As a rule, there should be one society in each village so that members might know each other fully well and exercise mutual control. This is necessary as the liability of the members is usually unlimited.

(3) *Liability.* Liability of the members is unlimited, unless an exception is granted by the Government. Unlimited liability enhances the credit of the society and stimulates the members to exercise proper

1. Statistics collected from the *Indian Year Book*, 1939-40.

vigilance and control in giving loans, in assuring that it is used for productive purposes and in pressing for punctual repayment.

(4) *Management.* The management of the Primary Agricultural Co-operative Society is honorary. There is usually a General Committee consisting of all the members and a Managing Committee of the selected few for carrying on routine and executive business.

(5) *Working Capital.* The society obtains the working capital in the shape of entrance fees, deposits by members, share capital, if any, and surplus assets in the Reserve Fund. These are the internal sources. The external sources of capital are loans and deposits from other societies, from Government and from Central and Provincial Co-operative Banks.

(6) *Objects of Loans.* Loans are given primarily for productive purposes and for the redemption of past indebtedness. Loans for unproductive purposes should not be theoretically given but they are granted lest the villagers might fall into the clutches of money-lenders.

(7) *Repayment.* Debts are to be repaid in easy instalments and punctuality in payment is stressed upon. The time of repayment is made to coincide with the time when the agriculturist is in the possession of funds.

(8) *Security.* Strictly speaking, no security should be taken from the borrowers and their honesty should be relied upon. But, in practice, sureties from amongst the members are furnished and collateral security is demanded.

(9) *Profits.* In the absence of share capital, the entire profit is credited to the Reserve Fund. But where there is a share capital, a part is allowed to be distributed amongst the shareholders. Sometimes a fraction of profits is permitted to be spent on religious and educative purposes.

(10) *Supervision.* The working of societies is subject to minute supervision and audit of the Registrar

of Co-operative Societies with a view to assure that they are functioning along sound lines.

B. Non-Agricultural Co-operative Credit Societies.—Credit difficulties exist not only in rural areas but also in cities and towns. Particularly when prices rise, wages are held in arrears, or standard of living increases, labourers and artisans feel the necessity of borrowing money. To solve this problem many non-agricultural co-operative credit societies of the Schulze-Delitzsch type have been started in various provinces and are making fair progress.

Non-Credit Co-operative Societies

In recent years the co-operative movement has made considerable progress along non-credit lines, in both agricultural and non-agricultural spheres. As regards *agricultural non-credit co-operative societies* many of them have been set up for obtaining implements, manures and seeds at low prices. Even co-operative insurance has been started. In the *non-agricultural sphere* also, successful attempts have been made to arrange for the purchase of yarn and silk for weavers, cane for basket makers, timber for carpenters and implements for several industries. The purchase and sale of most sorts of common necessities is being carried on at various co-operative stores².

Advantages of Co-operation in India

The co-operative movement in India has not yet developed to the fullest extent and the little progress that is made is not free from defects. Still the movement has conferred many advantages which may be briefly summarized as below :

Economic Advantages—We have already discussed the economic advantages of the agricultural co-operation, which is the heart and soul of the movement, in the preceding chapter. Other branches of the movement have not been barren of useful results. Agricul-

2. For instance, the co-operative movement in Bengal has, according to the 1939-40 Report, extended its activities in the following directions : (1) Sugar cane Growers' Union, (2) Fishermen's societies, (3) Multi-purpose societies, (4) Health societies, (5) Orange societies, (6) Rural Reconstruction Societies, (7) Irrigation Societies. See *Bengal Weekly*, 20th May, 1940

tural non-credit societies have done much to popularize improved seeds, cattle, cheap manures and implements. The problems of sanitation and medical relief have also been tackled. Non-agricultural societies though few, are doing quite good work and are ameliorating the lot of factory labourers, depressed classes and employees of all sorts.

(2) *Moral Advantages*—Besides economic advantages, the movement has toned up the standard of morality of its members. It has inculcated the spirit of economy and thrift. Much of the litigation, which had hitherto been a drain on time, energy and money of the poor, has stopped; the disputes are now settled by arbitration. Besides, a man of loose character and doubtful morality is not allowed to become a member of the society; and this restriction has tended to correct moral degradation to some extent. As Darling observes, "Litigation and extravagance, drunkenness and gambling, are all at a discount in a good co-operative society and in their place will be found industry, self-reliance and straight dealing, education and arbitration societies, thrift, self-help and mutual help."

(3) *Educative and Administrative Advantages*—The co-operative movement has educated people in diverse ways. A member of the co-operative society has the privilege of attending its meetings and has to understand its rules and regulations. If he is appointed to a responsible post, he has to make a closer study of the whole affair. Thus his intelligence is stimulated and his power of reasoning and understanding quickened and refined. In many cases, the necessity to read entries in pass books, or to make signatures has encouraged literacy. Side by side, a unique system of imparting education in administration and democracy has been provided and is bearing good fruits.

(4) *Social Advantages*—The movement has benefited society in more than one ways. The principle of unlimited liability calls for mutual vigilance and conditions public opinion against thriftlessness and extravagance. Extravagance on the occasions of

marriages and other domestic ceremonies are thus held in check. Much benefit has also resulted from the improvement in drainage system, the repairing of wells, the provision of medical relief, etc., organized under the auspices of co-operative societies.

Defects in the Co-operative Movement in India

The co-operative movement has not made sufficient progress in our country. The only problem to which the movement has mainly addressed itself is that of rural credit; and here too the work that has been done "amounts only to a scratching of the surface". This is the greatest shortcoming of the movement. Besides, it is also characterised with the following defects —

(1) *Lack of the Principles of True Co-operation*—There is a deplorable lack of the understanding of the principles of true co-operation. People have not yet entered into its true spirit and regard it merely an ordinary credit agency. They somehow feel that it is a Government movement and the Government have some ulterior motive behind it.

(2) *Mis-management*—There is a good deal of mis-management of the co-operative societies. As the Royal Commission on Agriculture pointed out, members of societies delay payments even when able to repay; office holders refrain from taking action against defaulters and the spirit of self-help is not prominent. Even when defects are obvious and admitted, there is reluctance, as dangerous as it is regrettable, to liquidate societies whose condition is beyond remedy. In particular, the economic purpose of the loan is not carefully scrutinized and the evil feature of overdues is very common.

(3) *Defective Audit*—It is of the greatest importance to have an efficient and thorough audit in order to prevent bad management and embezzlement and to inspire confidence in the public. The existing arrangements vary from province to province and are mostly unsatisfactory. Audit, supervision and inspection of societies, which are closely allied functions,

are now vested in two and sometimes in three different agencies, resulting in much overlapping of work and waste of effort and money.

(4) *Window-dressing.* The real work is generally neglected and people use their genius for window-dressing. This is probably not so in the Punjab where the movement has been a comparative success.

(5) *High Rates of Interest.* The rates of interest are still high in many provinces. To a certain extent this is inevitable, for two or three intermediate agencies, each requiring profits, interpose between the ultimate borrower and the original lender or depositor; the primary society, the central bank and the provincial bank, each adds something to the rate of interest payable to the depositor. Under ideal conditions, societies are expected to attract locally all the capital needed for the requirements of the members.

(6) *"Inelasticity, Dilatoriness and Inadequacy".* One of the greatest weakness of the movement consists in its inelasticity, dilatoriness and inadequacy. Members fail to get as much money as they want and whenever they feel its necessity. Unnecessary delay is sometimes involved in the process. One result is that members have to go frequently to the money-lender. Indeed, a habit has grown up among societies of taking up as much as they can from the Central Banks once a year and giving out the money to their members in a lump sum. The money received in a lump sum is spent as soon as it is received, and when other needs arise, money is again borrowed at exorbitant rates from money-lenders.

(7) *Lack of Consolidation.* Efforts directed towards the rectification and consolidation of existing societies have so far borne no fruits.

(8) *Predominance of Government Control.* In its inception, initiation and control, the movement largely remains a Government movement. The share of non-officials in it is very insignificant. In order to be a success, it must be a movement of the people, for the people, by the people.

CHAPTER XII

TRANSPORT

Good roads, canals and navigable rivers—by diminishing the cost of carriage—are the greatest of all improvements—*Adam Smith*.

§ 1. INTRODUCTORY

Early travellers into the interior of the New World were amazed at the sight of innumerable wild pigeons and of the vast pigeon roosts, covering thousands of acres, where those birds nested in such numbers as almost to break down the trees. An economist naturally wants to know how could these numerous birds find food for themselves and for the young which were multiplying so rapidly. The fact was that these birds were powerful large distance flyers and could forage over vast areas. Now, if you look to any of the modern cities of this country, does it not appear to be a human "pigeon roost"? How do its inhabitants keep themselves alive? Of course, by foraging over vast tracts with the help of the means of transport.

Our present-day society is very fundamentally dependent upon the means of transport which are very aptly likened to the veins and arteries of the human body just as the telegraph and telephone systems are likened to the nerves. Modern means of transport represent the great victory that Man has gained over Nature by annihilating distance and making the world shorter than before. The importance of the means of transport from social, political and cultural viewpoints cannot be too much emphasized. Their importance in economic sphere is, of course, supreme. The modern society of large scale production and world-wide trade is basically hinged on an efficient system of transport. Raw materials are brought by railways, ships etc., from various places of their origin and are unloaded in factories. The latter convert them into finished products and the means of transport take them away to national and international markets where they are sold to millions of consum-

ers. This is true of every modern industry; and is made an accomplished fact by cheap, easy and efficient means of transport.

Means of Transport

The means of transport have changed their character through the march of centuries. Originally, human beings were the only means of transport, of which the modern coolie is the typical example. Later on, the utility of animals as beasts of burden was found out and they became the important means of transport. Still later, water transport came into prominence: first the rivers were tried, because they were only moderately risky, and the experience gained there encouraged people to venture upon the ocean. It was followed by road transport when the improvement of roads and construction of conveyances became the fashion of the day. Next, steam was found out and railways were invented. The latest addition to the means of transport is, of course, the air transport.

Development of Transport in India and its Effects

The economic effects of the development of transport can best be illustrated with reference to India. The means of transport in ancient India were quite efficient and up-to-date. Later on, during the turbulent centuries separating the ancient and modern times, they fast deteriorated. Further improvements and extensions did not keep pace with the growing requirements and before the middle of the last century, they were in a very poor state. Roads were few, troublesome and unsafe; navigable canals were absent; and railways were yet to come. Strenuous efforts were thereafter made to improve the matters; and to-day we possess a fine transport system, though it still falls short of our needs.

The development of the means of transport has in recent times brought about fundamental changes in the economy of our country. (1) Before their advent, our industries were organized on small scale and were non-mechanized. But cheap, easy and quick transport enabled us to import machinery, chemicals and technicians from foreign countries and to establish modern large-scale and mechanized

factories. The facilities offered by means of transport in taking goods from factories to the doors of the distributors and consumers all over the country, also helped the growth of modern industrialism. The growth of modern industries was accompanied with the unfortunate decay of old cottage industries which, unable to withstand the competition of cheap factory goods, began to die away. (2) Again, the growth of our *trade and commerce* is largely due to this development. Trade and Transport are inextricably linked with each other and none can develop without the other. (3) But the most important effects are to be seen in the field of *agriculture*.

Effects on Agriculture—(a) The most important effect of the development of means of transport has been the *commercialisation of agriculture*. Formerly, our agriculture was known as "*subsistence farming*" as the cultivators then aimed at raising only as much produce as was necessary for their own subsistence or consumption. When the means of transport opened up markets in which agricultural produce could be profitably sold, cultivators began to raise the produce with the object of selling it in the markets. Agriculture was, thus, commercialized. (b) Formerly the market for agricultural products, such as it was, was only *local*. In times of famines, therefore, price went sky-high; means of transport were poor and inadequate and supply could not be rushed from prosperous areas. In times of good harvests, on the other hand, prices tumbled headlong because the surplus produce of the agriculturist could be sold only in the local market. This unsatisfactory feature of our agriculture has vanished now. In times of famines, food-stuffs are hurriedly brought to the affected area by speedy trains and bullock carts; and in times of bumper crops, the surplus produce is taken away by them to the places of scarcity where fancy prices are obtained. (c) Quick means of transport have also enabled the rural population to *produce perishable goods* like vegetables, fruits, eggs and milk etc., and to dispose them of in the markets before they begin to rot. (d) Means of transport have linked our far-flung and quiet villages with the busy towns and cities and the

latter with other parts of the world. Our villages have become a limb of the world economy and are now influenced by world conditions. For instance, the Crimean War brightened many a home of jute growers and the American Civil War brought prosperity to cotton growers. (e) Intimacy with towns has enabled agriculturists to purchase useful articles of everyday need at cheap prices; and to move to the industrial towns if they want employment. (f) Finally, means of transport have had an *educative influence* upon our cultivators. Their horizon of knowledge is widening and their religious fanaticism and provincialism, caste restrictions and conservatism, are being softened down.

§ 2. RAILWAY TRANSPORT IN INDIA

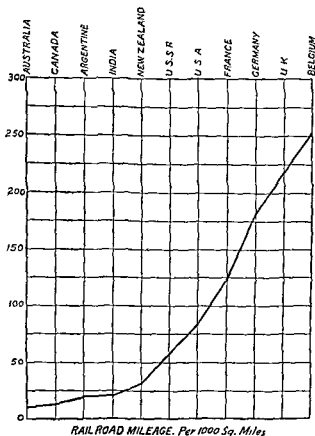
Short History

The railway is the most important means of transport in India. The construction of Indian railways on a serious scale dates from Lord Dalhousie's famous minute on the subject in 1853. The early railways were constructed by private companies under a *Guarantee System* whereby the Government guaranteed a return of 5 per cent per annum on the invested capital. The railway companies had no incentive to work efficiently and economically under this system; nor did they economise in capital expenditure obviously because a fair rate of return was assured to them in any case. The Government suffered heavy losses in consequence. The State, then, took up the construction of railways in its own hands in 1869. The new move was cut short by financial difficulties of the Government which had to entrust the task to private companies once again under the New Guarantee System in 1879. In 1900 railways showed profits for the first time. Since then a vigorous policy of railway extension had been launched till the Great War broke out. After the War, the Government appointed the Acworth Committee to consider the railway problem. In pursuance of its recommendations, substantial improvements have been effected in railway transport.

The Present Position

Under the New Guarantee System, the Government had reserved the right to purchase the railways

on certain specified terms, which they have been exercising of late. To-day the bulk of the trunk lines are owned by the State but the management is mostly with companies subject to Government control. India now possesses about 44,000 route miles¹ of railways. The total route mileage appears to be very small as for a country of such continental dimensions as ours. We have less than 25 route miles of railways per one thousand square miles of area, which is very low as compared to other countries of the world. The following chart is intended to illustrate the fact².



1. The actual figure at the end of March, 1937 was 43,128 miles.

2. Vide Dr. R. N. Dubey, *Economic Geography of India*, p. 168.

Railways have not yet penetrated into the rural areas which still lie unconnected with ports or big towns. The recent development of mechanical road transport has, however, reduced the necessity of railway extension to some extent.

The important railways of India are the following:

1. The North Western Railway.	7000 miles
2. East Indian Railway.	4400 ..
3. Great Indian Peninsula Railway.	3700
4. Bombay Baroda and Central India Railway.	3700 ..
5. Bengal Nagpur Railway.	3400 ..
6. Madras and South Maratha Railway.	3200 ..
7. South India Railway.	2500 ..
8. Bengal and North Western Railway.	2100 ..
9. Eastern Bengal State Railway.	2000 ..
10. Assam Bengal Railway.	1000 ..

Advantages of Railways

Railways have brought about remarkable changes in all spheres of our life—social, political and economic. The chief advantages they have bestowed upon the country are the following:—

(1) *Social Effects*—Railways have been so many links joining the once isolated villages with busy towns. They have consolidated the entire India into one compact whole in which the exchange of ideas and social intercourse are easy and frequent. By affording cheap and easy means of travel, they have encouraged the travelling habit of the people. A great benefit has thus accrued to religious pilgrims in particular. Travelling by railways is also safe: it is difficult to rob a train full of hundreds of passengers as against an iso-

lated bullock cart or palanquin. Indeed, railways played an important part in putting an end to *thuggery* once prevalent in India. Railways also render invaluable service in executing publicity campaigns for sanitary improvements, for the popularization of improved methods of agriculture, etc. Finally, by conferring upon the country a number of substantial advantages of economic character, they contribute to the richness of society.

(2) *Political Advantages*—The political advantages of railways are also great. They have put an end to internal dissensions, uprisings and wars, and have maintained peace within the country. Under their benign influence, India has emerged as one solid and unified nation with a strong Central Government. They afford protection against external aggression since military forces can be despatched from one part of the country to the other, according to the requirements with remarkable speed. Railways have also meant the active participation of the State in the economic life of the country and have thus negated the vain cult of *laissez faire* or non-intervention. Finally, they have opened up new ways and means of increasing the financial resources of the State whose functions are increasing daily. Since the railways are State-owned, their profits go to the State coffers. By increasing the wealth of the people, they add to their tax-paying capacity; while they provide great facilities in the collection of land taxes, customs etc.

(3) *Economic Advantages*—The economic advantages of railways are even more fundamental and far-reaching than their social and political advantages. Railways have benefited agriculture, forestry, industries and trade, while their influence on labour and capital has been very salutary.

(a) *Agriculture*. What we have written about the advantages of the development of means of transport and communication to agriculture apply here in *toto* . In brief, railways have (i) commercialized agriculture, resulting in the localisation and specialization of crops, (ii) extended markets, (iii) encouraged the production of perishable goods, (iv) connected our

agricultural economy with the world economy, (v) improved the economic status of agriculturists, and (vi) educated our cultivators in diverse ways. We may emphasize that the help rendered by them in famine relief has been very valuable, indeed. They have changed the very meaning of the word 'famine'; 'famine' formerly meant *a lack of food stuffs* but now it simply means *lack of employment*.

(b) *Forestry*. Railways have been very beneficial to forestry. Their construction creates a huge demand for sleepers, which encourages timber-growing. Besides, they also help in the exploitation of the forests and in the extraction of their major and minor produces.

(c) *Industries*. Railways have established modern industrialism. They have facilitated the import of machinery, chemicals and skill and the transport of coal and raw materials. The distribution of the enormous quantities of finished products all over the country has again been made possible by them. Railways have also stimulated engineering industries. They have also facilitated the exploitation of mineral wealth so indispensable for industrialization.

But they struck a fatal blow on indigenous cottage industries. They made possible the cheap, easy and quick transport of factory-made goods which sounded the death-knell of cottage industries.

(d) *Trade*. Railways have also stimulated trade and commerce. The economic history of the country shows that in the days of yore, our internal trade was meagre. But since the introduction of railways, it has increased tremendously because the cost and inconveniences of transporting goods have now been greatly reduced. They have also increased our foreign trade by assembling at the ports exportable commodities and by distributing throughout the country the imported articles.

(e) *Labour*. Railways have increased the mobility of labour and have brought about an even distribution of population. Workers have begun to shift

from villages where the pressure of population on land is heavy, to the areas of virgin soil or to the industrial towns where labour is scarce. Railways have created two main labour classes: railway workers' class consisting of engine-drivers, guards, station masters, coolies etc; and factory workers' class which has grown up with the growth of factories made possible by railways.

(f) *Capital*. They have brought to the country much foreign capital which has not been barren of economic advantages and which has encouraged the risk-taking instinct of our people.

Disadvantages of Railways

Railways are not an unmixed good and have certain demerits, though they are often over-emphasized. It is said that railways have brought about a *decay of cottage industries* and have thus withdrawn from cultivators an important source of subsidiary income. This, however, is true only to a certain extent. The defeat of handicrafts by factories has been a definite stage in the economic development of each and every country; the absence of railways might have delayed the moment of defeat but could not have made it improbable. In so far as the cottage industries which can hold their own against factory industries are concerned, they are now being revived and railways are contributing to their revival. Again, railways are accused of bringing about *one-sided development of the country*: by charging low freight on raw materials destined to ports and on imported manufactures intended for the interior markets, they have made the economy of the country disproportionately agricultural. This allegation is true; but this is the defect, not of railways, but of railway rates policy. Again, it is said that though railways have made the famine relief easy, they have at the same time increased the volume of the task by increasing the pressure of population on land through the destruction of cottage industries. This point has already been discussed and needs no repetition. Railway construction, it is also asserted

by the critics, led to indiscriminate cutting of forests, which had to be checked later on. Finally, they are held responsible for importing much foreign capital into the country, which has brought with it many economic and political disabilities.

§ 3. ROAD TRANSPORT

Short History

India has been in possession of efficient roads from times immemorial. Recent excavations at Mohanjo Daro and Harappa bear eloquent testimony to the excellence of the roads of ancient India. With the advent of the British rule, roads acquired a new strategic significance for the movement of troops. A vigorous road policy was launched by Lord Dalhousie who rendered similar service to railways also. The extensive construction of railways led to a certain neglect of roads, specially when there was competition between them. With the popularity of the mechanical road transport in recent years, roads have again come into prominence.

Present Position

According to the *Statistical Abstract*, the total length of metalled roads in British India in 1936-37 was above 80,000 miles, and of unmetalled roads, over 2,30,000 miles¹. The frame-work, with which the important subsidiary roads are linked, is constituted by four great trunk roads which stretch diagonally across the country. The most important of them is the famous Grand Trunk Road in Northern India joining Khyber to Calcutta. The other three connect Calcutta with Madras, Madras with Bombay and Bombay with Delhi. As regards subsidiary roads, the best and the most numerous exist in Southern India. Then there are unmetalled or 'kutchra' roads some of which provide good going for motor traffic during the dry weather. The provincial distribution

1. *Statistical Abstract for British India* (15th Issue) p. 604.

of metalled and unmetalled roads, and that of motor vehicles is shown in the following diagram⁴.

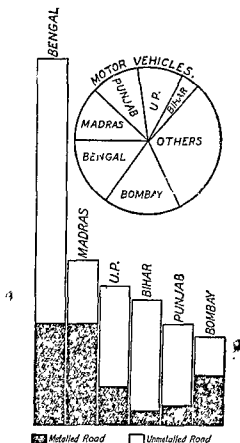


Diagram showing provincial distribution of roads and motor vehicles

Defects

Indian road system was altogether inadequate to the requirements of the country before the advent of motor traffic, which has brought the inadequacy in still bolder relief. The deficiency of roads is especially felt in rural areas many of which lie isolated, unconnected with railway stations or towns. Even the existing roads are not satisfactory. They lack co-ordination and continuity in programme. Not often, the absence of bridges and culverts militates

4. Taken from Dr. Dubey, *op. cit.*, p. 175.

against their usefulness. In recent years, the development on motor traffic has considerably deteriorated them.

Government Action

The increasing realization of these defects led the Government to appoint the Road Development Committee in 1927, whose functions were to examine the question of the development of road communications in view of the increasing use of motor transport, and suggest ways and means of financing it. In accordance with its recommendations, the import and excise duties on motor spirit were raised from 4 to 6 annas per gallon in 1929, the additional duty being meant to be spent on road development. This decision has since been amended twice, the resolution at present in force having been passed by the Assembly in 1937. It was passed that the special tax on petrol introduced in 1929 shall continue to be levied for road development, the proceeds of which, after retaining a reserve of 15 per cent for administration, research and special grants-in-aid, shall be allocated for expenditure in the different provinces, Indian States etc., in ratio of petrol consumption in the various areas. These sums may be spent on the construction, reconstruction or improvements of roads and bridges.

Necessity of Road Construction

We need more and improved roads for meeting the requirements of our continental country. Agriculturists cannot send goods to *mandies* and towns easily and cheaply so as to be able to sell their produce at high prices ruling there. Our forest wealth cannot be fully exploited due to the same cause. Our industrial development is also handicapped due to the insufficiency of good roads which are essential for the assembly of raw materials and distribution of finished products. They will also be valuable in the decentralization of industries and in developing cottage industries. Finally, if road transport increases and improves, our internal trade is likely to improve, considerably. For the all-round economic development of the country, therefore,

the construction and development of roads is absolutely essential.

Rail-Road Competition

With the increase of motor traffic, the competition between the road transport and railway transport has become acute. Motor transport is a product of the present century as railway transport was that of the last. And this problem, which was characterised by Lord Willingdon as "one of the growing pains of civilization", is to be found in almost all the countries of the world.

Railways and motors have, in fact, their own exclusive spheres of cheap operation. In the case of railways, huge capital has to be sunk in providing locomotives, wagons, stations, signals, sheds etc. The working cost is also enormous. No such outlay is necessary in case of road transport. Railways, unlike motors, also face the problem of carrying half-empty wagons and of keeping rolling stock idle. Again, railways have to pay for the cost and upkeep of their permanent way; but the cost of maintaining roads is mostly borne by general tax payers. It appears, therefore, that road transport is cheaper than railway transport. This, of course, is correct so far as short distance and light traffic is concerned. In the case of long distance and bulky traffic, railway transport is the cheaper of the two. For railways operate under the law of increasing returns or diminishing cost—the larger the scale of operation, the lower the cost. Obviously, then, long distance and bulky traffic should be allocated to the railways and short distances and light traffic, to the motors. There is no scope for competition here.

There is, however, a certain overlapping sphere of operation where there is competition between these two forms of transport. This is so in the neighbourhood of large cities and suburbs and where motor services run parallel to short circuit rail-roads. Railways are feeling the pressure of this competition and efforts are being made to find out a solution.

§ 4. WATER TRANSPORT

River Transport

Water transport consists of inland waterways and ocean transport. India is a land of many rivers but still the inland water transport is not much developed here because of several unfavourable geographical factors. Northern India possesses 26,000 miles of navigable water-ways approximately. The *Indus* is navigable up to Dera Ismail Khan and the *Ganges* up to Cawnpore. The southern rivers are swift and possess rocky beds; therefore, they are not important for navigation. Some of the Indian rivers become dry during the summer, which is injurious to their navigation. Again, there are difficulties in transporting goods from the banks of the rivers to the road or railway station, as the intervening land is usually sandy and unfit for vehicles. The shifting nature of Indian rivers makes the construction of harbours out of the question. However, the competition of railways has struck a fatal blow to the river transport. It was the opinion of the Industrial Commission that where railways and waterways compete with each other, the Government should carry on the administration of both of them side by side.

Marine Transport

The foreign trade of India is mostly overseas and is carried on by foreign shipping concerns. India does not possess a mercantile marine of her own. The Scindia Navigation Company, the only Indian steam navigation company, is groaning under the competitions of foreign countries. It is sometimes said that the nature of Indian coasts and distance of sea from the interior have failed to make up a sea-faring nation; the only ports of any consequence that we possess are Karachi, Bombay, Goa, Madras, Vizigattam and Calcutta. But in olden days India was an important sea-faring nation, and can certainly regain that importance once again only if opportunities for development are made available to her people. The absence of Indian element in marine transport is widely deplored in the country and it is increasingly believed that "a

country stood like a pendant amongst the vast continents of Old World, with a coastline of over 4,000 miles and with productiveness of numerous articles of great use unsurpassed elsewhere, is by nature meant to be a sea-faring country. Her ports are adequate in size and number to meet the various requirements of her products⁵.

§ 5. AIR TRANSPORT

Air transport is, at present, the least important means of transport in India but it has a bright future before it. India occupies a strategic position in the scheme of world air transport. The main international lines pass through India. The Imperial Airways (The English Lines), the Air France (the French Line) and the K. L. M. (the Dutch Line), all fly over the Karachi-Calcutta air route.

5. S. N. Hazi, *Economics of Shipping*, p. 365-66

CHAPTER XIII

TRADE OF INDIA

If India's total agricultural produce is taken into account, calculations show that for every acre of land producing goods, whether grain, oilseeds, fibres, tea, etc. for export, eleven acres are cultivated for local consumption—*Worswick*.

The trade of India can be studied under (1) Foreign Trade and (2) Internal Trade.

§ 1. FOREIGN TRADE

Salient Features of Foreign Trade

India's foreign trade is well developed though we do not compare favourably with the United Kingdom, United States of America, Japan and other important countries of the world, in this respect. In 1938-39, the value of the goods exported from the country came to Rs. 152.3 crores and those imported into it, to Rs. 162.9 crores. The *salient features of our foreign trade* are the following—

1. The most important feature of our foreign trade is that we export mostly raw materials and food stuffs and import mainly manufactured goods. Foreign countries purchase from us cotton, oil and ores etc., and send us back cloth, refined oil and purified ores at highly inflated prices. The total imports and exports are roughly constituted as below :—

Imports		Exports	
Manufactured articles.	75 per cent.	Raw materials and unmanufactured goods	50 per cent
Raw materials and unmanufactured articles	15 per cent.	Manufactured articles	25 per cent
Food, drink and tobacco etc.	10 per cent.	Food, drink and tobacco etc.	25 per cent
	100 per cent.		100 per cent

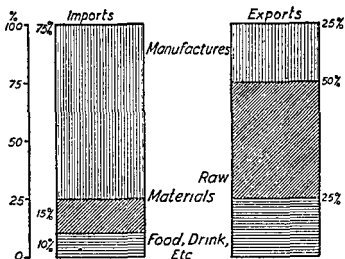


Figure comparing the exports from and imports into India.

Up to the opening decade of the last century, this was not so. Till then our industrial position was supreme and our exports consisted mostly of manufactured goods. But as a result of the subsequent growth of European industries and the economic policy of the Government of India, our industries languished and agriculture became the mainstay of our economy. The nature of foreign trade consequently changed. Since the Great War, manufactured articles have begun to figure slightly larger among exports than before. But still the situation is far from satisfactory. We should carry on the policy of rapid industrialization of this country vigorously, side by side with that of retaining food-stuffs and raw materials within the country unless there is a real surplus for export.

2. Usually we export more than what we import. In other words, the "balance of trade"¹ is, as a rule, in our favour. This balance is used by us in making payments for the "invisible" items of import, e.g., insurance premiums paid to foreign

1. By "balance of trade" is meant the difference between the exports and imports. If exports exceed imports, the balance is favourable; in the reverse condition, it is unfavourable.

insurance companies, freights paid to foreign ships, pensions paid to foreigners etc. If still a balance is left, it is imported in the shape of precious metals.

3. Our foreign trade is mostly in the hands of foreigners. Exporters and importers are generally foreigners. Shipping and insurance companies are mostly foreign. Exchange Banks are, again, all foreign. It is a matter of mortification and regret to us that while even small and unimportant countries like Netherlands and Sweden have their own shipping, insurance and banking companies, we are almost completely devoid of them.

4. Practically all the foreign trade of India passes by sea. The countries on our land frontier are poor and backward, selling little and buying little.

5. The sea-borne trade of India is concentrated to a few main ports, *viz.*, Bombay, Calcutta, Karachi and Madras. Sometimes 6/7 ths of the entire foreign trade flow directly to, or through, them.

6. The United Kingdom dominates our imports as well as exports. In 1913-14, the share of the United Kingdom in our total imports was 60% and in our total exports 20%. Recently both the figures have fluctuated nearabout 30 per cent.

7. On the whole, our foreign trade per head is very small as compared with the United Kingdom, United States of America or Japan. It is an index of our economic backwardness.

8. In recent years, the imports of sugar and cotton manufactures have registered remarkable fall. India has developed her own sugar industry under a protective policy and does not require foreign sugar. The growth of Indian cotton textile industry and the spirit of *Swadesheeism* have discouraged the imports of cotton manufactures.

9. Our exports, it may be noted, being mostly of agricultural commodities, depend upon rainfall,

When rains fail, they shrink to a low figure; and go up if rains are good and crops heavy.

We shall now make a detailed study of the chief articles of import and export and comment on each of them briefly.

Imports of Merchandise

The following table, from the one drawn up by Dr. T.E. Gregory, Economic Adviser to the Government of India, shows the comparative importance of the ten principal articles imported by us:—

IMPORTS

(In thousands of rupees)

Names of Articles	1936-37	1937-38	1938-39
1. Cotton and Cotton Goods	21,44,91	27,68,17	22,66,20
2. Machinery and Mill work	12,76,40	17,14,93	19,04,78
3. Oils	16,15,81	18,69,99	15,62,41
4. Grain, pulse and flour	14,18,63	12,16,85	13,76,46
5. Metals and Ores.	9,10,54	13,39,34	10,86,52
6. Vehicles	6,22,38	8,92,30	6,68,26
7. Instruments, apparatus and appliances	4,97,36	6,13,36	5,85,27
8. Paper and paste board	2,60,34	4,14,71	3,22,93
9. Dyeing and tanning substances	3,06,86	3,94,06	3,11,20
10. Chemicals.	2,54,37	3,32,82	3,05,29
Total value of Imports	1,41,70,08	1,73,78,57	1,52,32,77

(1) *Cotton and Cotton Goods*—The most important item in the list of imports is that of cotton and cotton goods. In the year 1938-39 we imported Rs. 22-7 crores worth of cotton and cotton goods, of which cotton constitutes a minor part. Imports of cotton goods came to about 15% of the total imports. Before the Great War of 1914-18, this percentage was 40 but due to the development of the indigenous cotton industry and the progress of the *khadi* movement, it has come down to 15 only. Of equal interest is the variation in the sources of supply. The United Kingdom is finding India a disappointing market and Japan and China are increasing their share. Of the total imports in 1938-39, the United Kingdom supplied 13 per cent. and Japan 58 per cent (as compared with 30% and 67%, respectively, in the preceding year). China, whose main ports have passed in the hands of the Japanese, was able to increase her share to 29 per cent in 1938-39.

(2) *Machinery and Millwork*—We import every year machinery of various types for our factories. Electrical, agricultural, sugar, tea, cotton, wool and other types of machinery are regularly imported. In the year 1938-39, we imported machinery costing Rs. 19-7 crores constituting 12½% of the total imports made during the period. Our imports of machinery during 1938-39 exceeded the figure of 1937-38 despite a reduction in the activities of some of the important Indian industries. The chief sources of supply are the United Kingdom, Germany and the United States of America which sold us 59%, 16% and 11% of the total imports of machinery during the year. In recent years the percentage share of the United Kingdom has gone down due to the severe competition of Germany whose share has gone up. Imports of such items as electrical plant, mining machinery, oil crushing machinery, refrigerators and type-writers etc., having advanced, the share of the United States of America, which supplies these things to a great extent, has also improved.

(3) *Oils*—Of the total imports, mineral oils claim 10% approximately during the year 1938-39, their actual

total value being Rs. 14.7 crores. Mineral oils consist of fuel oil, kerosene oil, lubricating oils, benzine and petrol etc. Our most important supplier is Burma. U. S. S. R., Iran and United States of America follow in order.

(4) *Grain, Pulse and Flour*—The total value of grain, pulses and flour imported during the year 1938-39 was Rs. 13.8 crores. The item claimed about 9% of the total imports.

(5) *Metals and Ores*—The value of metals and ores imported into India during 1938-39 was Rs. 13.7 crores, coming to about 7 per cent of the total value of imports.

(6) *Vehicles*—Approximately 5 per cent of our total imports is devoted to vehicles whose value in 1938-39 came to Rs. 6.7 crores. Vehicles include motor cars, motor omnibuses, vans and lorries, cycles etc. The chief sources of supply are the United States of America and United Kingdom and Canada.

(7) *Instruments, Apparatus and Appliances*—We imported during the year under review Rs. 5.8 crores worth of instruments, apparatus and appliances, coming to 3 per cent of the total imports: under this head are included such things as electric fans, wires, cable, telegraph and telephone instruments, electric lamps, batteries etc. Our main sources of supply are the United States of America, United Kingdom and Germany.

(8) *Paper and Paste-board*—We import paper and paste-board from the United Kingdom, Germany, United States of America and Norway etc. The total value of such imports in 1938-39 was Rs. 3.2 crores, coming to about 2 per cent of the total imports.

(9) *Dyeing and tanning Substances*—We also import dyeing and tanning substances. In the year 1938-39 they amounted to Rs 3.1 crores forming 2 per cent of the total imports.

(10) *Chemicals*—The total imports of chemicals in 1938-39 were valued at Rs. 3 crores, being equal to the items of paper and paste-board, and dyeing and tanning substances.

Other Items—There are many other items that we import. Of these the most interesting are liquors and sugar. The total import of *liquors* comes to about 5 million gallons. Bombay takes the largest quantity and is followed by Bengal, Sindh and Madras. About 60 per cent of the imports come from the United Kingdom and the remainder from Netherlands, Germany and Japan. The imports of *sugar* were important some years back but since the Indian Sugar Industry has developed, they have declined considerably in recent years.

Exports of Merchandise

The following table shows the chief items of export from this country and their value in the last three years.

EXPORTS

(In thousands of rupees)

Names of articles	1936-37	1937-38	1938-39
1. Jute Manufactures	29 10 40	29 07 76	26 26,11
2. Cotton	43 93,25	29,77 26	24 66,65
3. Tea	20,21 83	24 38 69	23 42 47
4. Seeds	18,59 54	14,18 65	15 09,22
5. Raw Jute	14 77,10	14,71,90	13,39,67
6. Grain, Pulse and flour,	6,56,97	9,48,89	7,74,12
7. Cotton manufactures	7 02,30	9 29 30	7,11 79
8. Leather	7 44,37	7,25 42	5 27,58
9. Metals and ores.	3,67,61	6,12,60	4 91 02
10. Wool raw and manufactured.	3 76 00	3,72,37	3 84,67
Total value of Exports	1,85 04 93	1,80,92 42	1,62 92,55

(1) *Jute Manufactures*—Jute manufactures top the list of the articles of export. The value of goods exported in 1938-39 amounted to Rs. 26 crores and constituted 16 per cent of the value of total exports. They consist of jute bags and jute cloth. The exports of both have been declining recently as foreign countries are trying to develop their own jute manufacturing industry. We supply goods to the United Kingdom, United States of America, Australia, Canada etc.

(2) *Raw Cotton*—We exported Rs. 25 crores worth of raw cotton in 1938-39, coming to about 16 per cent of the total exports made in the period. Our best customer is Japan. During the year under review, the Japanese purchases contracted because of the war-time economic measures in that country. Our next best customer is the United Kingdom, with France and Germany following suit.

(3) *Tea*—About 80 per cent of the entire tea produced in the country is exported, most of which finds its ways to the United Kingdom. Canada and United States of America are scanty purchasers. In 1938-39 our tea exports came to Rs. 23 crores, i.e., 14 per cent of the total exports.

(4) *Seeds*—Export of oil seeds comes next in order. Groundnuts and linseed form the bulk of the exports. Our exports in 1938-39 amounted to Rs. 15 crores, constituting 9 per cent of the total value of exports. The export of oil seeds is injurious to us. We import back the oil extracted from these seeds at heavy cost and also lose the valuable manure left after the extraction of the oil. It is necessary to develop the oil extracting industry in India and to prevent this great national loss.

(5) *Raw Jute*—We exported raw jute, valued at Rs. 13 crores, during the year 1938-39, which comes to 8 per cent of the total exports. Raw jute goes mainly to United Kingdom, France, Germany and Netherlands. As new substitutes for jute are being painfully discovered with some success, our exports are also declining, though the process is slow.

(6) *Grain, Pulse and Flour*—The export of grain, pulse and flour came to Rs. 7.7 crores in 1938-39, equal to 5 per cent. of the total imports.

(7) *Cotton Manufactures*—We export cotton manufactures to Burma, Ceylon, Straits Settlements and Egypt. In 1938-39 the exports went down but still they were valued at Rs. 7.1 crores, about 4 per cent of the total exports. The export of cotton manufactures should be maintained and encouraged as the Indian cotton industry is passing through hard times within the country and must find out some foreign markets.

(8) *Leather*—We exported Rs. 5 crores worth of leather in 1938-39, constituting 3 per cent of the total exports.

(9) *Metals and Ores*—In 1938-39 their value was Rs. 4.9 crores and their percentage of the total exports, 3%.

(10) *Wool*—We exported Rs. 3.8 crores worth of wool to other countries, most of it being raw. The percentage to the total exports borne by wool was 2. United Kingdom is our best customer and United States of America follows suit.

Other Items—Other interesting articles of exports are raw hides and skins, oil cakes, tobacco, raw rubber etc.

Direction of India's Foreign Trade

Imports				Exports			
	Percent				Percent		
	1936-37	1937-38	1938-39		1936-37	1937-38	1938-39
United Kingdom	31	30	30.5	United Kingdom	31	33	34
Burma	20	15	16	Japan	15	10	9
Japan	13	13	10	U. S. A.	10	10	8.5
Germany	8	9	8.5	Burma	5	6	6
U. S. A.	5	7	6	Germany	5	6	5

Most of our foreign trade is carried on with the United Kingdom, Burma, Japan, Germany and the United States of America. The share of the *United Kingdom* in the export as well as in the import trade of India is about $\frac{1}{3}$ rd. *Burma* was formerly a part of India but has now been separated. This separation has meant loss to us since we import more from Burma than what we export. *Japan's* share in our exports and imports has fluctuated round about 10 per cent in recent years. The share of *Germany* in our imports is 10 per cent while in exports it is about 5%. The share of the *United States of America* was, on 1938-39, 6 per cent in our imports and 8.5 per cent in exports. Generally speaking, the United Kingdom and Europe dominate our import trade while many countries significantly participate in our export trade with the United Kingdom holding the supreme position.

Since the beginning of the present century, our trade has tended to divert from the United Kingdom and to deflect towards Germany and Japan, the two rising nations of the world. (a) In 1900, the share of the United Kingdom in our import trade was 69 per cent; of Germany 2.4%; of the United States of America 1.7 per cent; and of Japan 0.6 per cent. In 1913-14 the share of the United Kingdom dropped down to 64.1 per cent and of others increased to 6.9 per cent, 2.6 per cent and 2.6 per cent respectively. The significant increase in the share of Germany was due to the cheapness and suitability of her goods to Indian needs and her vigorous selling campaign. During the great War, imports from the United Kingdom and Germany dropped down as both were engaged in War, and Japan and the United States of America increased their shares. After the War, the United Kingdom continued to lose her hold on India due to the political situation in this country while Germany began to recoup the lost ground. Afraid of this tendency, Ottawa Trade Agreement was rushed through, according to which Great Britain was given certain preference in India from January 1, 1933. Consequently her share improved slightly in subsequent years. But

recently her share has again declined. Japan lost a part of her share immediately after the War but again increased her share later on. Germany has also showed remarkable recovery. (b) Let us now examine our *export trade*. In the beginning of the present century, the share of the United Kingdom in our export trade was 29 per cent; that of the European countries, 25 per cent; and of United States of America, 7 per cent. In 1914, the figure for the United Kingdom declined to 25 per cent and of others rose to 29 per cent and 9 per cent respectively. During the Great War our exports were diverted to the Allies. But after the War was over, the old tendency re-asserted itself. The most noteworthy feature recently has been the importance that Japan has achieved in exports, as also in imports.

Invisible Imports and Exports

So far we have discussed the export and import of those items which are recorded in the custom returns or in other published statistics. They are known as "visible" imports and exports. There are, on the other hand, certain items which are not so recorded, the so-called "invisible" items.

The *Invisible Imports* into India are mentioned below;—

1. We have to pay interest on loans raised abroad; we, thus import the use of the loans taken.
2. When we repay foreign loans, money goes out. We import back the securities. This is a debit item.
3. Remittances are made to Indian students studying abroad. This is a payment made for the education and other materials purchased or imported by India through the medium of its students.
4. Money is paid by Indian tourists for the services and amenities purchased by them abroad.
5. Payments have to be made for the services purchased from foreign insurance, shipping and banking concerns.

6. Foreigners carrying on business in India remit profits to their relations abroad. It is a payment made by India for the enterprise and business risk imported by her.

7. Home charges, i.e., the expenditure on Government account in foreign countries in connection with pensions, furlough pay, stores, bullion etc., purchased by the Government of India.

Our Invisible Exports are as below :—

1. Loans raised abroad. When we raise a loan in foreign country, we export securities.

2. Foreigners often make remittances to India for the support of schools, missions etc. This is the payment which we get for exporting charity, as it were.

3. Tourists coming to visit India purchase many goods and services and pay therefor.

Balance of Trade and Balance of Accounts (or Payments)

The difference between the exports and imports of merchandise is called the Balance of Trade. If our (visible) exports exceed (visible) imports, the balance of trade is said to be favourable; and in the opposite case, the balance is said to be unfavourable. India, as a general rule, has a favourable balance of trade.

A complete statement of our international indebtedness should include not only merchandise but also in visible items. The net balance of both visible and invisible items is named as Balance of Accounts or Balance of Payments. It is favourable or unfavourable according as the country has to receive or pay something in the final settlement of accounts. During the Great War of 1914-18, our balance of accounts was favourable to the tune of Rs. 35 crores on an average. In 1936-37, it was favourable to the extent of about 21 crores.

§ 2. INTERNAL TRADE

Internal Trade falls under two categories: Coastal Trade and Inland Trade.

Coastal Trade

The trade conducted along the coast line and meant to carry articles from one part of the country to another part of the same country is described as the *coastal trade*. The volume of trade is much too considerable—about Rs. 200 crores.

Our coast line is very extensive and, though not quite as indented as that of, say, Britain, it is amply provided with harbours. But most of the old harbours have been allowed to be silted up. Again, our coastal trade warrants the existence of an Indian mercantile marine of fair size; but it is undeveloped. Efforts must be made to take full advantage of our capacity to develop the coastal trade. For this purpose, our ports must be developed, our mercantile marine built up and railway and coastal traffic properly co-ordinated.

Inland Trade

By Inland trade we mean inter-provincial trade carried over land. Our country has vast dimensions. Its population is tremendous. The variety of crops raised and goods produced is equally remarkable. Naturally our internal trade is bound to be much more important than our external trade. It is not ordinarily easy to compute the inland trade of a country definitely. It is especially difficult in our country which lacks adequate and efficient statistics. Professor K. T. Shah mentions that the maximum figure for the total foreign trade of India attained hitherto is Rs. 600 crores; and the figure of inland trade has been computed by him at Rs. 1,500 to 1,600 crores. In other words, inland trade is only about three times of our foreign trade. In England the inland trade is about 20 times as great as the foreign trade. In the United States of America also, the internal trade is ten times of the external trade. This suggests the possibilities of development in our internal trade also, which cannot be neglected without grave prejudice to the permanent interests of the country.

Amar Narayan Agrawal

DISTRIBUTION

It has now become certain that the problem of distribution is much more difficult than it was thought to be by earlier economists, and that no solution of it which claims to be simple can be true. Most of the old attempts to give an easy answer to it, were really answers to imaginary questions that might have arisen in other worlds than ours, in which the conditions of life were very simple.

—Marshall

CHAPTER I

THE PROBLEM OF DISTRIBUTION

All wealth that is created in society finds its way to the final disposition of the individual through certain channels or sources of income. This process is called Distribution—*Seligman*.

§ 1. INTRODUCTION

Meaning of Distribution

Distribution of wealth is the fourth branch of Economics which we shall now study. By Distribution we mean the method by which the wealth produced is divided between the parties who co-operate in producing it¹.

In modern times production of wealth takes a co-operative form. Landlords, capitalists, labourers, organisers and entrepreneurs, work together in the productive activity. Therefore, the wealth which they jointly produce belongs to all of them. The problem that arises is: How to distribute the wealth thus produced amongst the agents taking part in its production?

The answer seems to be simple. Each of them, it may be said, should be given a share of the joint product proportionate to his share in the effort. This principle of distribution is as fair and equitable as we would like it to be; but the difficulty is that it cannot be put into practice. We have no instrument or method by which we can measure the share of each producer in the productive effort and proportion the share

1. Wray Hunt *Man and Wealth*, p. 26.

Wicksteed writes, 'What is understood by "distribution" as a branch of Political Economy is the study of the principles on which the product of any complicated industrial process is distributed amongst those who have in any way contributed towards securing it'—Wicksteed, *The commonsense of Political Economy*, p. 359.

in the wealth produced accordingly. As Penson rightly observes, "How is it possible to separate the result of each man's efforts from that of the effort of the group? One man has worked as an engineer, another as an invoice clerk; one has been engaged in some process of manufacture, another in conveying the finished goods to the warehouse. It would be difficult to determine what each of these has contributed to the final result."² The difficulty is great, indeed. But, in spite of it, wealth is distributed among the agents of production. What are the principles, then, according to which the distribution of wealth actually takes place in the modern society? Are these principles just and fair? If not, what changes in the present method of the distribution of wealth are necessary? Such are the problems to which we address ourselves in the branch of Economics known as Distribution. *Distribution may, therefore, be described to be the descriptive, critical and constructive study of the principles according to which wealth is distributed amongst the agents of production concerned*³.

Another Meaning of Distribution

The word *distribution* is used in another sense as well. It sometimes means the distribution of commodities amongst its purchasers—consumers and sellers. The means of transport and commercial organizations like shops are called *distributive agencies*. In the present

2. Penson, *The Economics of Everyday life*, Part I, pp. 137-38.

3. Distribution may be *Functional* or *Personal*. Under *Functional Distribution* we discuss how each factor of production obtains a given money income in the form of rents, interest wages and profits, which is exchanged for a share of the total consumption of goods. *Personal Distribution* discusses how individual persons obtain a given amount of wealth and income. Functional Distribution makes an attempt to explain how the price of a factor of production is determined. Personal Distribution explains inequalities in the distribution of wealth and income among individuals—See Ely and Wicker, *Elementary Principles of Economics*, Part IV, chapter I. Also James, *An Outline of the Principles of Economics*, Ch. XIII.

context, the word "distribution" is not used in this sense⁴.

Origin of the Problem of Distribution

In the primitive days, each man worked alone and with his own resources. A weaver, for instance, purchased yarn from the spinner, prepared the cloth himself or with the aid of the members of his family, and sold it in the market for whatever he could get in exchange. The money thus obtained belonged to him and to nobody else. The question of distribution did not arise at all. By slow degrees, this stark individualism and economic independence sank into the yawning gulf of time, to be replaced by social life and economic interdependence. Productive efforts began to assume a co-operative character on an increasingly extensive scale; tens and hundreds of men began to work together to produce each commodity. The wealth thus produced belonged to all of them and the question of distribution arose in the natural course of things⁵.

4. In popular discourse, the term *distribution* often refers to the transference of commodities from place to place or from person to person, or, in other words, the term refers to the operations of wholesale and retail trade. Logically, distribution in this sense is part of production. Distribution in the economic sense (here adopted) refers to the division of the wealth of a nation amongst the different classes—Nicholson, *Elements of Political Economy*, p. 95.

5. The following sentences give a vivid description of the old order of things and the new order, "The case of the peasant proprietor presents no such difficulty (of distribution). It may be assumed that he farms his own land, that he does all the necessary work and that he owns seed, stock and implements. The relation between effort and income is readily seen. He sells his crop or his dairy produce as the case may be; he keeps back as much of the proceeds as is necessary to replace seed and stock, and to repair his buildings and fences, the remainder is the income resulting from his effort. But such a condition of industry is far from typical at the present day, at any rate in the more industrial countries of the world. Large numbers of men work together in the same factory or mine, under another man's direction and control, in building owned by some one else, and with materials, machinery and tools which are not their own. Land-owners, capitalists, employers and workers have all contributed to the production of wealth and all will receive a part of it as income. It is by no means clear, however, what any one of these has contributed to the final result or to what share of product he is entitled". Pearson, *The Economics of Everyday Life* Part I p. 138

Before the Industrial Revolution, which occupied approximately one hundred years in England beginning from 1750 to 1850, the problem of distribution was not an important issue. It was the Revolution which accentuated the co-operative feature in productive processes and increased the scale of production. The modern problem of distribution may, as such, be regarded as its legacy to the posterity.

Conflict in Distribution

Since there is no accurate measure of the just share of each agent of production, conflicts over distribution of wealth often arise. *Landlords* demand a very substantial share on the ground that they supply land or natural resources which fundamentally give rise to the finished products. *Capitalists* likewise assert that they provide machinery, implements and money without which production on any important scale is not possible; their contribution is very valuable and their share should be equally big. *Labourers* say that it is they who actually convert materials into finished products; if they cease to work, the entire productive machinery will come to a standstill. Still they get small wages, just sufficient to keep themselves alive, other agents of production unjustly appropriating what really belongs to labourers. This theory is the inspiring motive of that great movement of Socialism which is spreading like wild fire in every country of the world. *Organisers* claim that the efficiency of entire production depends upon their bringing into effective co-operation the various factors of production. *Entrepreneurs*, not to lag behind, maintain that it is they who undertake the risk. If risk is not undertaken production will be stunted to the irreducible minimum of necessities for existence. Because of these conflicting claims, the subject of distribution has become the most controversial and the most important branch of Economics. In passing it may be added that in the present-day organisation of society, labourers appear to be unjustly treated in the matter of distribution of wealth: their contribution is solid and substantial but their reward is very little.

§ 2. THE PROBLEM OF DISTRIBUTION

The problem of distribution resolves itself into three main issues :—

(1) What exactly is there to be distributed?

(2) Who are entitled to a share?

(3) How distribution takes place and what determines the amount of each individual's share in income?

(i) What is to be Distributed?

The question, what is to be distributed, appears to be very simple. A beginner may give a quick reply, "Evidently whatever is jointly produced by the agents of production, is to be distributed." This answer is, however, not quite correct. The whole wealth produced is not available for distribution. A fraction of it has to be used for making good the capital consumed in its production, whether the capital is *circulating*, which is consumed in a single operation, or whether it is *fixed*, which wears out gradually. Again, taxes have got to be paid out of it. The balance left after making these provisions is the amount available for distribution.

(a) *The Replacement of Circulating Capital*—During the productive process, the circulating capital is used up and has to be purchased again before further production is possible. In a furniture factory the stock of wood has to be purchased as soon as it is used up so that the manufacture of furniture may be continued. Similarly, in case of a shoe factory, leather has to be replaced from time to time for the same reason. From the total wealth produced we must, therefore, set apart a certain sum for such replacement.

(b) *Depreciation and Replacement of Fixed Capital*—Fixed capital, like machinery, implements and

ploughs etc., lose their value with the passage of time, through wear and tear or otherwise. This gradual loss in value is known as depreciation. Fixed asset depreciates gradually till it becomes worthless and requires replacement. Its probable life can be estimated and during the period of its use, a certain sum is annually set aside in a Depreciation Fund such that when the asset becomes useless, sufficient money is available in the Depreciation Fund to purchase a new asset. For instance, if the price of a machinery is Rs. 1,000 and its estimated life, 10 years, Rs. 100 will be added annually to the Depreciation Fund. After ten years, when the machinery becomes worthless, Rs. 1,000 become available for the purchase of another machinery. Provision is thus made out of the total wealth produced for the depreciation and replacement of fixed capital.

(c) *Taxes*—Citizens have to pay various State and Municipal taxes so that the Government and semi-Governmental bodies may discharge their functions efficiently. A part of wealth produced is taken away by the State in the shape of taxes⁶.

The total wealth jointly produced by the co-operative agents of production is known as *Gross Product*. The wealth left after meeting the above three demands is known as the *Net Product*. It is the Net Product which is available for distribution.

Example—The total wealth produced by a shoe factory in the year 1939 is Rs. 1,000. It employs a circulating capital of Rs. 200 and provides annual depreciation on fixed asset of Rs. 50. It pays Rs. 50 as taxes each year. Find out its Gross Product and Net Product.

The answer is simple. Rs. 1,000 is the Gross Product and if we deduct from this sum the replacement charges of circulating capital, depreciation on fixed capital and taxes ($\text{Rs. } 200 + \text{Rs. } 50 + \text{Rs. } 50 = \text{Rs. } 300$),

6. For a lucid explanation, see Moreland, *An Introduction to Economics*, pp. 235-238.

we arrive at the Net Product, namely (Rs. 1,000—Rs. 300)=Rs. 700.

The following diagram illustrates the point.

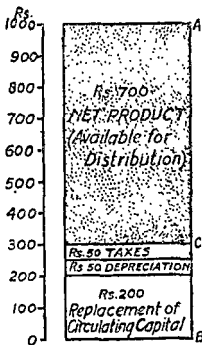


Figure explaining the constituents of Gross Produce.

National Income or National Dividend—If we add up the Net Products of all the productive enterprises of the country during a given period, we arrive at the total Net Product available for distribution among its inhabitants. This total Net Product is called *National Income* or *National Dividend*. Marshall explains the concept of the National Dividend as follows. "The labour and capital of the country acting on its natural resources, produce annually a certain *net* aggregate of commodities, material and immaterial, including services of all kinds. This is the true net annual income or revenue of the country; or, the National Dividend⁷."

7. The word National Dividend is used in its arithmetical sense as the amount to be divided, and not in its commercial sense, the amount shared out. It must not be looked upon as a store accumulated by a year's labour, sacrifice etc., but rather as a stream continually flowing and being continually used up—Crew, *Economics for Commercial Students*, p. 85.

We may, of course, estimate it for the year or for any other period".⁸

(2) Who are Entitled to a Share?

The answer to this question is simple enough. Those are entitled to a share of Net Product, who have contributed to the productive effort. The factors of production are five, namely, Land, Capital, Labour, Organization and Enterprize. Those who supply them get a share⁹. Landlords get rent, Capitalists; interest; Labourers, wages; Organizers, salaries; and Entrepreneurs, profits.

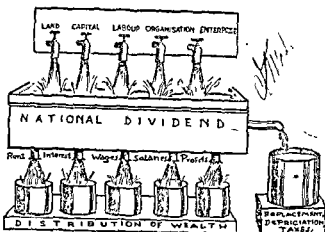


Figure illustrating the origin and distribution of the National Dividend.

8. Marshall. *Principles of Economics* (1930 Ed), p. 523.

Pigou defines National Dividend as "that part of the objective income of the community, including of course, income derived from abroad, which can be measured in money—Pigou, *Economics of Welfare*,"

9 The following is a graphic description of the origin and distribution of the national dividend: we "may regard the contribution of each productive unit as being added to a vast reservoir of wealth into which flows continually the result of the efforts of all classes in the community. The reservoir represents the national or social wealth of the community which from day to day is being added to by its economically active citizens, and, on other hand, is being continually drained of some or of all its surplus by four great streams which in total represent the national dividend or social income and individually form the incomes at present respectively to the four great classes in Society landowner, labourer, capitalist and entrepreneur" Thomas, *Elements of Economics*, p. 237.

Organiser and Entrepreneur—Some writers make no distinction between the entrepreneur and organiser⁹, obviously meaning thereby that both the functions of risk taking and organisation are, in their opinion, rolled together in the same person. This view is not quite correct. In these days, the work of organisation has become so technical that men with special aptitude, training, and experience alone can do this work satisfactorily, the qualities not necessarily possessed by a risk-taker. Sometimes the constitution of the business unit itself makes the division in these functions absolutely essential. In the case of a joint stock company, for instance, all the shareholders are entrepreneurs, or risk-takers; but and all of them cannot obviously take part in management. Paid organisers or managers are, therefore, employed for the purpose. In such cases, then, organisation is not supplied by the same persons who supply enterprise. These considerations show the advisability of treating organisation and enterprise as two different factors of production¹⁰.

It must not be supposed that an individual can supply only one factor of production. In fact, there are many cases in which one person supplies many factors of production at the same time. Shareholders of a joint stock company are risktakers; they are also capitalists as they supply capital. The dividend, which they receive on their shares, contains (1) interest on the capital supplied by them, and (2) profit for the risk that they undertake. Again, take the case of a managing partner. He supplies capital, undertakes the risk and does the managerial duties. He is an entrepreneur, a capitalist as well as an organiser.

(3) *Method of Distribution*—The issue of the method of distribution concerns itself with the following:—

- (a) How distribution actually takes place? and
- (b) What determines the share of each agent of production?

9. Marshall and his followers belong to this class.

10. This is also the view of American economists in general.

(A) *How Distribution takes place?*—Older economists were at a loss to understand how distribution takes place. They gave very vague explanations of the phenomenon. Adam Smith, for instance, wrote that the total produce, "is naturally distributed among the different ranks of people". John Stuart Mill, similarly, maintained that this produce "distributes itself by spontaneous action". These explanations are obviously unilluminating and do not make us any the wiser.

The method of distribution¹¹ obtaining in modern society, though complex, may be explained in simple words as below. The entrepreneur works as the distributor. Before actual production is commenced, he calculates how much produce is likely to be sold and at what price. This gives him *Gross Produce*. Then he subtracts from *Gross Produce*, the replacement and depreciation charges and taxes to be paid to the Government. The balance is the *Net Produce*. The above calculation requires estimation and forecast; but as he is supposedly in the know of the actual facts and is experienced, his estimation is generally a near approach to accuracy. After finding out the Net Product available for distribution in this way, he proceeds to make bargains with landlords, capitalists, labourers and organisers for the supply of land, capital, labour and organisation respectively, taking care that a sufficient margin is left from the *Net Produce* for himself. Production is then commenced and goods are sold as they are produced. In the end, if the net produce realised exceeds the sums paid out as rent, interests, wages and salaries, the surplus is the reward or profit of entrepreneur; if the former falls short of the latter, the entrepreneur suffers a loss.

(B) *How is the Share of each Agent of Production Determined?*—This is the most difficult and important problem of Distribution. The only other problem which shares this credit is the problem

11. Penson has explained this point very creditably in his book, *The Economics of Everyday Life*, Part I, pages 143-144. Text book writers on the subject have generally followed him.

of justice in distribution, which is too advanced to be administered to the beginners.

Each factor of production, it must be remembered, is just like a commodity and its reward is determined by the interaction of demand and supply. Entrepreneur, when purchasing a factor of production, has a maximum price to offer; he will not pay more than that. His maximum is determined by the marginal productivity of a particular factor of production, just as in the case of an ordinary commodity, the maximum of the buyer is determined by the marginal utility of the commodity¹². The owner of a factor of production has a minimum price determined on a rough estimate of expenses of production; he refuses to accept a price lower than this. Between these maximum and minimum limits, the price is determined according to the relative forces of demand and supply existing at the time. The reward of the entrepreneur, as we have already stated above, is the residue of the Net Product left after the satisfaction of all other claims.

It is, indeed, the study of the determination of the share of each factor of production which constitutes the main body of the subject of Distribution. Distribution, it will be realized, is merely the application of the theory of value to various factors of production.



2. It shall be discussed in detail in succeeding chapters.

CHAPTER II

MOBILITY OF FACTORS OF PRODUCTION

Some of the earlier European writers on Economics assumed the existence of what may be called complete Mobility of Labour, they assumed, that is that labourers would go to work wherever the inducements were greatest almost as certainly as water will flow downhill until it reaches the lowest possible level. Such perfect Mobility probably does not exist—*Moreland*,

§ 1 INTRODUCTORY

Before discussing how the reward of each agent of production is determined, we shall address ourselves to the subject of the mobility of factors of production.

Meaning of Mobility

The word *Mobility* is generally used with reference to a factor of production. Mobility, according to dictionary, means the capacity to move easily. The inability of a factor of production, therefore, implies its capacity to move from one place or use to another place or use, easily and quickly. Land, labour, capital, organisation and enterprise, are all mobile in varying degrees.

Advantages of Mobility

Mobility of a factor of production is advantageous in several respects :—

(1) *Proper Distribution*—If mobile, a factor of production easily changes the place or field of its application; it moves from the place where it is abundant to one where it is comparatively scarce. Thus, the curious paradox of the plenty of a factor at one place and its scarcity at another within the same country and at the same time, becomes a thing of the past, and the resources of the country are well organized to secure the maximum national dividend.

(2) *Equalisation of Reward*—Due to the mobility of a factor of production, its owner is enabled to

employ it in the most remunerative channels. This tendency ultimately results in the wide-spread equalization of reward of that factor of production.

(3) *Equalization of Marginal Productivity*—As a result of the mobility, an *entrepreneur* is able to follow the law of substitution. He substitutes a cheap factor of production for a dear one till he finds that the marginal productivity, i. e., the wealth produced by the marginal or final unit, of each factor of production is equal. This is known as the *Law of Equi-marginal Productivity*. A faithful adherence to this law, made possible by the mobility of various factors of production, is the hall-mark of efficient organisation and is compatible with maximum profit.

Obviously, the mobility of various factors of production is advantageous to their owners, their employers and the country as a whole alike.

The Assumption of Free Mobility

The orthodox or classical economists assumed the free flow of the factors of production from less profitable to more profitable fields of their application. This is the necessary corollary of free competition. In actual practice various obstacles stand in the way of free mobility. Perfect mobility, like perfect competition, does not actually exist. Since the assumption of free mobility in the classical theories is removed from reality, they sometimes become hypothetical in their nature.

§ 2. MOBILITY OF LAND

Land cannot move from one place to another; in other words, place mobility is not possible in the case of land. But if it is being put for one use at any time, it can be put to some other use subsequently. For instance, a plot of land used for the growth of millets can be made to grow wheat. Again, land used for agricultural purposes can be utilised for constructional purposes. But land devoted to the construction of buildings cannot be used for cultivation unless the building has long disappeared.

There are various obstacles hindering the mobility of land from one use to another. Due to

sheer conservatism, cultivators may refuse to grow maize on a plot of land so far devoted to millets, though the former might be more profitable; or, they might not possess sufficient knowledge for the cultivation of the latter while they might be well qualified for the former. Lack of proper equipment, seeds, and such other things might check them from changing the crop raised. Marketing difficulties might also forbid any change. Happily, all such obstacles to the mobility of land are gradually losing their force.

§ 3. MOBILITY OF LABOUR

Meaning and Kinds

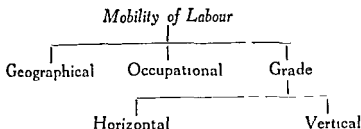
By the mobility of labour we mean its ability and willingness to move from one place, occupation or grade to another place, occupation or grade. Mobility of labour is of three varieties :—

(1) *Geographical or Place Mobility*—The movement of labourers from one place to another is known as Geographical or Place Mobility. The movement of a labourer working in Allahabad to Benares or Calcutta is an instance of geographical mobility.

(2) *Occupational Mobility*—If a labourer changes his occupation, his mobility is said to be Occupational Mobility. If a driver becomes a clerk, his mobility is occupational.

(3) *Grade Mobility*—The movement of labour with respect to the grade of work is known as *Grade Mobility*. The mobility of labour in the same grade is known as *horizontal mobility*. For instance, a fireman in a glass factory might move to the job of a fire-man in another glass factory, if he gets higher wages, more leisure or better treatment there. The movement of labour from one grade to another grade is known as *vertical mobility*. The promotion of an assistant manager to the post of a manager is an example of vertical mobility¹.

1. Writers have not paid as much attention to Mobility as it deserves. The classification of the mobility of labour is not always free from vagueness and ambiguity. The present classification has been formulated and given here as it seems to me the most satisfactory.



These varieties of Mobility of Labour are not mutually exclusive; i.e., it must not be understood that a particular case of mobility can be only of one variety and not of more than one. On the other hand, a case of mobility may be geographical, occupational as well as grade. Suppose a man from Allahabad working as an unskilled labourer goes to Cawnpore to work as a carpenter, his mobility is geographical, since he has changed the locality; occupational, since he has changed occupation; and grade, since he has been promoted to a higher grade. But horizontal and vertical mobilities, being the two types of grade mobility, do not overlap. A mobility may be either vertical or horizontal.

Geographical Mobility

Geographical mobility of labour is common everywhere in the world. In our country, though not of considerable importance at present, it is definitely increasing. Geographical mobility is either permanent or temporary. Sometimes labourers leave one place for good and settle at another place permanently. It may happen due to *social causes* like ex-communication, *economic causes* like the sale or dispossession of land or better conditions of employment available elsewhere, or *religious causes* like Hindu-Muslim riots. Permanent mobility is not so important in India as temporary geographical mobility. Cultivators generally go to the neighbouring industrial towns during the off season, when they are idle, only to come back to their fields after a short period. The hill exodus of Government offices, occasional transfer of Government officials and movement of labourers to the place of fairs or *meals*, are other instances of temporary mobility. Temporary mobility is encouraged by lack of employ-

ment and climatic and technical, political and administrative considerations.

Labour is the most difficult factor of production to move from one place to another because of various personal considerations, in spite of the fact that such movement is economically profitable to them. But with the spread of education, dissemination of knowledge regarding possibilities of employment at other places, and under the pressure of struggle for existence, labour has begun to move from place to place.

Occupational Mobility

Mobility from one occupation to another occupation takes place when the general attractiveness of the latter exceeds that of the former. The following are the factors that attract labourers from one occupation to another:—(1) *High wages.* Other things remaining the same, an occupation promising higher wages will attract more labourers as compared to those occupations where wages are low. (2) *Agreeableness of work.* Agreeableness of the work attracts labourers and its disagreeableness repulses them. (3) *The ease of learning the business.* If a business is easy to learn, it becomes more attractive to labourers as compared to one which necessitates difficult, costly and long apprenticeship. (4) *The regularity and security of employment.* If the employment is secure and regular, it is very attractive to workers. (5) *The possibilities of success and rise.* The occupation where chances of success are great and the scope for progress is considerable, is always liked by workers. (6) *The degree of trust reposed in the worker.* If the employment requires a high degree of honesty and sincerity, the reward and prestige attached to the office are considerable. It becomes attractive to men endowed with integrity and honesty but unattractive to those who lack these qualities. It may be emphasized, however, that though all these factors have a telling effect on occupational mobility, the most important of them is the first one, namely the rate of wages. Other factors are static and do not vary

considerably from time to time; therefore, they exert little influence on occupational mobility.

The occupational mobility of labour also depends upon its skilled or unskilled nature. Unskilled labourers have to do the work which requires no skill or training, whatever might be the occupation. As such, they can easily move from one occupation to another under the influence of increased wages. Skilled labour, on the other hand, is specialized. Skilled labourers in a particular occupation are specially trained for the purpose; and while they may be very suitable for the jobs they have been trained for, they may be misfits, or no better than unskilled labourers, in other occupations. As such, skilled labour is not very much mobile occupationally.

The inability of skilled labour for occupational mobility is weakening gradually. As education is increasing, certain branches of knowledge and training hitherto confined to comparatively few persons are becoming the possession of almost everybody, and the gulf between skilled and unskilled labour is being levelled up. Again, the spread of machinery and the division of labour to an ever increasing extent, have simplified each task to the maximum degree and have made them very much alike.

In India occupational mobility is little, due to the lack of education, absence of machinery and conservatism of the people. It has been made smaller still by the rigid caste system prevalent amongst the Hindus. According to this system, the occupation of a man is determined at the time of his birth and he cannot change it without arousing social disapproval and opposition, which few can risk. For instance, a milk-man cannot dare doing the work of a cobbler lest he might be ex-communicated. Similarly, a cobbler cannot think of becoming a sweetmeat seller lest he might displease the members of the society and might rot in hell in the next world for spoiling the religious faith of others. The caste system certainly has the advantage that it preserves the hereditary skill and is a wonderful system of family apprenticeship. But

it becomes vicious when no exceptions are made to it. In our opinion persons of one caste should be allowed to change their occupation if (1) the demand for labour is comparatively high in other occupations, which is expressed by high wages prevailing there; or (2) if they have natural bent towards other occupations. Luckily, the caste system is weakening with the spread of education and the growing realization of its demerits. Signs of dissatisfaction against the system have already begun to appear and are very likely to bear fruits in course of time.

Grade Mobility

Grade mobility, as said above, may be horizontal or vertical.

Horizontal Mobility—The mobility from one grade to another may be in the same occupation. For instance, a labourer working in a particular sugar factory may have a cruel boss; he will, then, take the first opportunity to move to another sugar factory whose boss is kind and considerate. Horizontal mobility in the same occupation is not so important as the horizontal mobility from one occupation to another. In the latter case, all considerations discussed above regarding occupational mobility apply with equal force.

Vertical Mobility—Mobility from one grade to another may be upward or downward, i. e., a worker may move from a particular grade to a higher grade or to a lower one. It is easier to move down the scale than to move up.

The movement to a higher grade is possible in the following cases :— (1) If worker becomes distinctly efficient for a higher grade through education and experience, he might scale up. (2) If the demand for men able to fill up the posts of higher grade increases as a result of increased demand of the product of that industry, an opportunity for vertical mobility of this type arises. (3) If the labourers of the higher grade are somehow incapacitated or die or are withdrawn

from the work due to certain reasons, labourers of lower grade get promotions.

Labourers go down from a higher grade to a lower grade if they lose efficiency or if unemployment spreads.

Hindrances to the Mobility of Labour in India

Of all the agents of production, labour is said to be the most immobile. Labour is inseparable from labourers: the two move together. As such, many personal factors hindering the mobility of labourers become obstacles to the mobility of labour as well. Besides, many extra-personal factors also exert influence on the movement of labourers and, therefore, of labour. In India, the mobility of labour is hindered by the following factors :—

(1) *Love of Home, Place or Occupation*—Love of home, family ties, affection for a particular locality and appreciation of life in the country as opposed to dislike of life in the town, obstruct the geographical or place mobility of labourers. Love for a craft or the feeling of family pride in it, hinders occupational mobility. A man, being what he is, cannot generally raise himself above such personal considerations.

(2) *Lack of Ambition*—If a labourer is satisfied with his present lot, he has no ambition to move. In western countries labourers are very materialistic and are constantly on the look out to raise their standard of living. Indian labourers, on the other hand, are fatalistic and of a spiritual bent of mind. They think that their financial position is determined by the fate, and cannot be improved. Moreover, they always think in terms of the next world where they will go after their death, which makes them care more for religion than for money.

(3) *Social Customs*—The rigid social customs of India, which act as a drag on the wheels of progress in general, also hinder the mobility of labour. Of such social customs, caste system and the joint family

system are the most important. We have already discussed how the caste system checks mobility. The joint family system is a similar obstacle in the path of mobility. In western countries, a family consists of the husband, the wife and minor children. In India, on the other hand, the family is joint in the sense that it consists of a large number of families. As a matter of fact, father and mother, uncles and brothers, along with their wives and children—all live together. This system certainly has the advantage that each member works according to his capacity and gets according to his need. The old, the infirm and the unemployed are properly looked after. But it checks geographical mobility by strengthening family ties. Again, it is prejudicial to one's ambition because personal employment is not proportioned to income and, as such, hinders occupational and grade mobility.

(4) *The Nature of Occupation*—Sometimes the nature of occupation is such that a movement results in loss of efficiency. This is particularly true in case of agriculture which is the occupation of the majority of Indians. If a cultivator moves from one place to another, he might have to face strange climate, soil and crops. A substantial part of his old knowledge might become useless and new training might become necessary. This is one important reason why our agriculturists are not mobile. This is not so with artisans who can move from town to town and village to village with their bag of implements doing the same work in the same fashion.

(5) *Difference in Surroundings*—India abounds in languages, religious, and social customs, climatic conditions and modes of living. This brisk variety discourages geographical mobility. Life amidst strangers speaking different languages, following different social customs, eating different food and wearing different clothes, becomes very difficult indeed.

(6) *Poverty of the Masses*—The people of the country are very poor and find themselves unable to bear the expenses of migrating from one place to

another where they might expect to get better reward. Again, due to poverty they cannot get training and education necessary for vertical mobility.

(7) *Lack of Means of Transport and Communications*—Means of transport and communication are not very wide-spread, cheap and easy in our country. Where difficulty exists, geographical mobility is hindered. This obstacle was very important in the past but it has lost much force due to the recent developments in the means of transport and communication.

(8) *Ignorance*—Ignorance of the want of knowledge of the place and occupations where high wages may be expected is an important obstruction to geographical, occupational and grade mobility. As most of the people are illiterate, generally ordinary posts are not advertised. Other means of information like labour exchanges, information side of the trade unions and State guidance into the matter, are conspicuous by their absence. Where, however, information is available, mobility of labour is a common feature to be met with. For instance, many labourers from the villages of the United Provinces have gone to Bengal and Behar to work in factories and the information sent by them to their villages of the high wages that they earn has been responsible for the mobility of labour on a large scale.

(9) *Primitive Conditions of Work*—Over the greater part of the country, old methods of production are followed. Spread of machinery and the division of labour have not yet made much headway. As such, occupational mobility is hindered.

All these obstacles have made the typical Indian labourer stay-at-home and satisfied with the occupation and grade he happens to be attached to. Luckily, the force of these factors is losing vigour, though gradually. Under the stress of circumstances and the contact with westerners, social customs are losing their hold, caste system is weakening and joint family system is breaking asunder. Means of transport have improved considerably, particularly due to the advent

of motor lorry transport. Primitive conditions are undergoing a change. Large scale industries are being set up in all directions and for all purposes. Mechanisation and division of labour are spreading. And mobility of labour is increasing as a consequence.

§ 4. MOBILITY OF CAPITAL

By mobility of capital is meant its ability and willingness to move from one place or use to another place or use. Capital is the most mobile factor of production. Capital can be physically detached from its owner; therefore, the various and diverse personal factors like love of family, attachment to surroundings etc., which influence the mobility of labour do not influence the mobility of capital. Moreover, capital can be easily and cheaply transmitted over long distances unlike labourers for whose transport conditions are not so simple.

The financial mechanism of a nation is the usual agency through which transfers of capital are made. In the modern age (a) a capitalist wanting to withdraw capital from, say, shares of cotton textile companies and to re-invest it in those of, say, iron and steel industry may simply ask his *stock exchange brokers* to do the needful. (b) Some capitalists deposit money with a bank and leave at their option, the investment, withdrawal and re-investment of capital. (c) There are some capitalists who may re-invest capital directly in a business where their control is supreme. For instance, a man might set up his own firm of, say, sugar manufacturing and withdraw, for the purpose, money invested in tea shares or deposited in a bank.

Factors Leading to the Mobility of Capital

The most important conditions governing the mobility of capital are its security and its profitability, i. e., the rate of interest obtainable. Unless the capitalist is sure that the new channel of investment is reasonably safe and sound, he will not ordinarily like to risk his capital in it. Other things remaining the same, the order of preference follows the order of

security. The rate of interest obtainable is another important consideration. Of the two investments equally secure, one giving high rate of interest will be preferred. The importance attached to either of these factors of production, depends upon the temperament of the investor. Cautious investors give more weight to security, while speculative investors are more attracted by profitability.

Other subsidiary factors governing the mobility of capital are (1) the existence of satisfactory and diverse channels of investment, which is dependent upon the economic progress of the country, (2) the existence of rapid means of communications and transmission of capital; (3) the political stability of the region of investment; and (4) the development of the financial mechanism.

The mobility of capital varies according to its liquid or fixed character. Liquid capital, i.e., cash and goods which can be easily converted into cash, possesses a high degree of mobility. For instance, capital invested in securities always purchased and sold in stock exchange markets can be easily disposed of and the capital withdrawn to be put to some other use. Fixed capital, on the other hand, is not so mobile. Capital invested in buildings, machinery etc. cannot be easily withdrawn. The sale of such goods takes time and involves loss.

Mobility of Capital in India

Capital in India is not very mobile. (1) As the country is in the infancy of economic development, many new ventures are certainly being embarked upon, but their security is yet untried and their profit yielding capacity still problematical. Under the circumstances, the mobility of capital cannot be great. (2) Our financial mechanism is not well developed. Banks have not yet penetrated into the interior. Moreover, they lack in variety. This hinders mobility. For instance, if a man in the village Phulpur wants to close down his grain shop and to invest this money in the bank deposits, he finds that he cannot do so, there being no bank in his village. Stock exchange

markets are also very few and not available to all. (3) Lack of enterprize. channels of investments are few in this country as people lack the spirit of enterprize. They do not have the courage of starting new ventures. (4) Dishonesty. Usually bogus companies are started and capital is raised under high sounding promises but within a short period the capital is dissipated in the rich salaries and other payments to the promoters; and very soon the concern goes to the wall. This is very discouraging to investors. (5) The industrial policy of the State. The policy of the Government towards our industries is step-motherly. The policy of discriminating protection followed by the Government does not assure the entrepreneurs that if they start a new industry, it will receive proper support from the Government.

But conditions are fortunately changing for the better, though by slow degrees. New ventures are coming into existence. Cement factories, cigarette factories, hydro-electric works, etc., are coming into prominence. Attention is being paid to the development of banking and stock exchanges. Agitation for a sympathetic industrial policy of the State is being carried on. It is expected that in course of time conditions will become favourable for the mobility of capital.

§ 5 MOBILITY OF ORGANIZATION

Organization is of the nature of high grade labour. Organizers are highly educated individuals and being sufficiently progressive as a general rule, are mobile geographically. Vertically, too, they are very mobile. Some difficulty, however, arise in case of occupational mobility in so far as the organisational problems of an industry are peculiar to it.

§ 6. MOBILITY OF ENTERPRIZE

By mobility of enterprize we mean the capacity of risk-takers to move from one occupation to another where reward is high, in proportion to the risk. In our country enterprize is slowly developing. For-

merly its mobility was very little. Our entrepreneurs used to take the minimum risk and to float concerns for the objects found profitable by their foreign compeers in this country. But with the spread of education, growing contact with western industrialism and economic advancement of country, the mobility of enterprize is increasing. The luke-warm industrial policy of the State, which we have already referred to, is the most important obstacle in the way and needs an immediate revision.

11/12/15 1/6/25 1/2/25 1/2/25 1/2/25
11/12/15 1/6/25 1/2/25 1/2/25 1/2/25

CHAPTER III

RENT

The exchange in value of all commodities, whether they be manufactured or the produce of the mines, or the produce of land, is always regulated by those who continue to produce them under the most unfavourable circumstances. Corn is not high because a rent is paid but a rent is paid because corn is high. Rent is not a component part of the price of commodities—*Ricardo*.

§ 1. MEANING OF RENT

Scientific Meaning of Rent

It was said in the preceding chapter that the share of the national dividend accruing to the landlord is called rent. Rent may, therefore, be defined as the income which accrues to the landlord from the ownership of any natural agent such as land, mines, water-power etc. As Marshall puts it, the income derived from the ownership of land and other free gifts of nature is commonly called Rent¹. From the point of view of the entrepreneur, rent may be said to be the payment for the use of land².

Ricardo's Definition—Ricardo's definition of rent is sometimes quoted with approval in the text-books of Economics and committed to memory by students. According to Ricardo, "Rent is that portion of the produce of the earth which is paid to the landlord for the use of the *original and indestructible* powers of the soil". This definition of rent, however, is not quite correct. The following are its inaccuracies :—

1. Marshall, *Economics of Industry*, p. 52.

2. In some cases, capital applied to land cannot be distinguished from it and obeys the economic laws concerning land. It is then considered to be a part of land and income from it is known as rent. Rent may, therefore, be more comprehensively defined as the payment which is made for the use of the primary factor in all production land or natural resources, including any capital which may have been so sunk in the soil as to obey the economic laws concerning land and to be no longer distinguishable as capital—Thomas, *Elements of Economics*, p. 243.

(1) Ricardo restricts the term rent to the payment made for the use of "soil" or "land". He excludes other free gifts of nature. As such his definition is too narrow.

(2) The expression "*the original and indestructible powers of the soil*" is not a happy one. Fertility, which is an important factor in determining rent and value of land is definitely destructible. Again, there are some properties of the soil which are not original but which are not distinguishable from land. Capital sunk in the land after pretty long time becomes indistinguishable from land and obeys the same economic laws which land obeys. The income from such acquired power or property is rightly regarded as rent³.

Popular Meaning of Rent

The scientific meaning of the term "rent" should be distinguished from its popular sense. In the popular sense the term is applied to the periodical payment for the use of a house including the ground on which it stands, a farm or an estate, or of a forest, a fishery, or a mine. According to this definition, rent includes not only payment for the use of land but also interest on capital invested in buildings and elsewhere, depreciation of fixed capital, and profit. For instance, the payment which a tenant makes to his landlord for the use of his house includes not only rent in the economic sense but also interest on the capital spent in the construction of the building, its yearly depreciation, and remuneration for the risk or enterprise. Students should remember that Economics is not at all concerned with the popular sense of the

3. Value of land depends upon its fertility or situation or both. In agricultural land, both the qualities are important. In urban sites, only situation is important. "Just as a given application of capital and labour will give a larger return on some soils than others, so will a given application of capital and labour give a bigger return on some sites than others. The same hat will sell for a bigger price in Bond Street than in new Oxford Street"
—Clay, *Economics for the General Reader*, pp. 351-352.

term "rent"⁴. Whenever they come across the word "rent" in any book on the subject of Economics, they should take it to apply in the scientific sense.

Rent and Tenancy

It should not be thought that rent necessarily implies the existence of the *tenant* and the *landlord*. In other words, it must not be supposed that rent is the payment which the *tenant* pays to the *landlord* and that it cannot arise unless land is let out by the latter to the former. As a matter of fact, landlord can use his land in either of the two ways: he may let it out to a tenant, or himself use it productively. It is in the first case that he gets a fixed annual payment called rent. In the second case, he does not receive any such reward; but he may well be supposed to be his own tenant and to pay the rent to himself⁵.

§ 2. ECONOMIC RENT AND CONTRACT RENT

Economists divide rent, in its scientific sense, into *Economic Rent* and *Contract Rent*, a difference of fundamental and vital importance.

Economic Rent

Land differs in quality fairly briskly. Some plots of land are very fertile and very favourably situated; others, comparatively unfertile and unfavourably situated. At a particular time, there is some land under plough whose fertility, or location, or both, are worst of all the cultivated tracts, so much so that it

4. Rent is popularly thought of as a payment made for the privilege of enjoying the use of any material object, a piece of land, a house, a boat, or anything you please. As used by most economists, on the other hand, rent means only a payment made for the use of *land*, that land, further, being conceived as unmodified by human art, or at least modified only in certain very fundamental, and substantially unalterable, ways.—F. M. Taylor, *Realings in Economics*, p. 181.

5. The owner may be the cultivator, in which case he gets the rent. The owner may be the community, which then gets the rent (this is the socialist proposal, which would not abolish rent, but transfer it to the State) or, the owner may have let his land to a farmer. In this case the farmer pays the rent to the owner—Hunt, *Man and Wealth*, pp. 30 31.

cannot afford to pay any rent. This is called the *No-rent Land* or *Marginal Land*. The output of every other land under plough is greater than that of the No-Rent land. The *surplus produce* or *differential gain* arising on super-marginal lands is called *Economic Rent*. It may, therefore, be defined as the *surplus or differential gain accruing to the owner of the land by virtue of its relative advantages of fertility, or location, or both, over the No-rent land*.

Contract Rent

The rent which is actually paid by the tenant to the landlord for the use of land is known as *Contract Rent*. It is called contract rent because it is determined by a contract between the parties concerned. Contract rent of a land may be equal to, or greater than, or less than, its economic rent. Under free competition, the rent actually paid is equal to the economic rent. If competition among landlords is comparatively greater than that among the tenants, or if some custom or law prejudicial to high rents is in force, contract rent may be less than the economic rent. On the other hand, if tenants compete more freely among themselves than landlords, or if some custom or law operates against tenants, contract rent may exceed economic rent⁶. The practice of charging a contract rent in excess of the economic rent is called "rack-renting."

Determination of Contract Rent

Contract rent is the price paid for the use of land and, like the price of any other commodity, is deter-

6. It is easy to conceive of conditions which may cause contract rent to differ from economic rent. Thus an unwillingness to leave a farm which had been held by parents and grand parents may serve to induce a submission to the exaction of a rent which leaves an inadequate remuneration to the farmer for his labour. Similarly, a landlord may be unwilling to press an old tenant, even though the land has risen in value. Further capital invested in the soil cannot be withdrawn at short notice. Some improvements may take years to exhaust, and a tenant, who was unable to secure adequate compensation for unexhausted improvements effected at his cost, might lose less by renewing his lease at a rent higher than the land without those improvements could bear, than by abandoning the values represented by improvements—A. W. Flux, *Economic Principles*, pp. 102-103.

mined by the forces of demand and supply.

Demand for the Use of Land—The cultivator agrees to pay rent for a plot of land because he thinks that if he were to cultivate it, he would get a return which would enable him to pay all the expenses of cultivation, to get an income for himself and to have a surplus which he can pay as rent. This surplus is the maximum that he will be willing to pay to the landlord. Good land yields a larger surplus per acre than a bad land; the tenant's maximum, as such, will be higher in the former case than in the latter. In other words, his maximum will vary with the character of soil and the location of land—the nearness of the market, facilities for marketing, and the price he is likely to get for the produce⁷.

Supply of the Use of Land—The landlord may use the land himself or may be willing to let it out. In the latter case there is said to be a supply of the use of land. The landlord calculates in his own mind, the surplus which may accrue to him if he cultivates the land himself. This surplus is the minimum which he will charge as rent for the use of his land. If he does not get this minimum as rent, he might cultivate the land himself or put it to some other purpose.

Determination of Contract Rent—The contract rent is determined by the inter-action of the demand for and the supply of the use of land. The greater the intensity of the demand and keener the competition among tenants relative to supply, the more will be the tendency of contract rent to reach the maximum. On the other hand, the greater the urgency of the supply and keener the competition amongst landlords relative to demand, the more will the contract rent tend to reach the minimum. Generally speaking, in new countries where land is abundant and competition among landlords very great, contract rent is usually low. In old countries, particularly when they are thickly populated, competition among tenants is enormous and contract rent is, more or less, equal to

7. For an able discussion of the factors affecting the utility and comparative utility of land, see Richard M. Hurd, *Principles of City Land Values*.

economic rent. Sometimes cultivators pay even more than the economic rent in case competition is very keen among them or if they have no occupation besides agriculture to follow. This is called rack-renting and is common in India.

- Determination of Economic Rent

We shall now consider how economic rent is determined. Theory of Economic Rent is a very important problem of distribution. When the expression "Theory of Rent" is used without any adjective before Rent, usually economic rent is meant. We shall devote the following section to this discussion.

§ 3. THEORY OF RENT

The theory of economic rent was first propounded by David Ricardo (1773-1823), one of the most distinguished of the English Classical economists, and is called the Ricardian Theory of Rent. In this theory Ricardo, followed by later economists, focussed his attention on agricultural land only. Other natural gifts were excluded from consideration, since the principles enunciated here apply with equal force to them as well.

Nature of Land

In order to be able to understand Ricardo's theory of rent we should first understand certain fundamental points about land.

(1) Land differs in fertility. Some plots of land are more fertile than others, i. e., the application of equal doses of labour and capital results in a higher yield in some cases and less in others. It is this difference in fertility, combined with variations in locality, which gives rise to a surplus or differential gain on the super-marginal lands. This surplus is economic rent.

(2) The cultivation of land is subject to the Law of Diminishing Returns. The return due to the application of particular dose of labour and capital is less than that due to the preceding dose. As such,

all the doses enjoy surplus or differential gain over the final or marginal dose. This surplus, as we shall presently see, is economic rent.

(3) Rent depends upon two main qualities of the land—fertility and location. The more fertile a land, other things remaining the same, the higher will be its rent. Its location has similar influence on rent. Location implies, among other things, nearness of market, facilities of transport and the price prevailing in the market. Rent is the payment for the fertility and location of land.

Ricardian Theory of Rent⁸

Ricardo started with the supposition of a vast tract of a virgin land just colonized by a small number of men. Since the land is abundant and idle, no payment need be made for its use. Rent will not arise at this stage. The settlers will cultivate only the best land, and competition will reduce the price of the agricultural produce just to the level of the expenses of production.

With the passage of time, the population of the colony will increase through births, or immigration, or both. The demand for agricultural produce will increase as a consequence and inferior land will have to be brought under plough. Now the application of an equal number of doses of labour and capital will yield heavier crop on the superior land and smaller crop on the inferior land. The surplus yield of the superior land over the inferior land is the economic rent. The inferior land, it may be mentioned, is unable to pay any rent: its expenses of production (not considering rent) are just equal to the price of agricultural produce—were they more, still inferior land would have been

8. Ricardian Theory of Rent consists of three distinct theories, viz, an *historical theory* as to the origin of Rent, a *statical theory* as to the causes that, at any time and place, determine the nature and utility of Rent, and a *dynamical theory* of the causes which continually tend to increase Rent. For an able discussion of these theories, see Prof. Maffeo Pantaleoni, *Pure Economics*, P. III, Ch. IV. (Translated from the Italian by T. Boston Bruce). Also see Sidgwick.

cultivated; were it less, it would not have been cultivated at all. It is, therefore, no-rent land. The landlord will take away the entire surplus on the superior or super-marginal lands in the shape of rent. He will not get less than that because cultivators would compete for the better plots of land, till the entire differential advantage disappears. He cannot get more than this surplus; otherwise cultivators will cultivate only inferior lands.

If the population increases still further, even third-grade land will be brought under plough and consequently rent on A grade land will increase while that on B grade land will begin to appear. This phenomenon of an increase in the rent of the super-marginal land and the appearance of rent on the (hitherto) marginal land will go on repeating itself as population increases and sub-marginal land is picked up for cultivation⁹.

Illustration

Let us assume that the supposed colony possesses four grades of land. The first grade of land is cul-

9. In the present discussion, Carver briefly sums up. We are concerned with the nature of rent, why it accrues and the laws by which its amount is determined. As to the first question, we have found that rent is that income which is derived from the ownership of an original and natural agent of production, as to the second, that it accrues because that agent is scarce, and as to the third, that the amount of rent is determined by the joint operation of the productiveness and the scarcity of land, being in each individual case determined by the amount which the use of the particular piece of land in question adds to the product which could be secured without it and this amount itself being determined by the amount of land of that grade as compared with all the other factors with which it co-operates in the work of production,—in other words, by the marginal productivity of that grade of land. This is only another way of stating the classic law of rent, viz. that the rent of any given piece of land is what it will produce over and above what could be produced on the poorest land in cultivation by the same amount of labour and capital for this difference is one way of measuring the amount which the piece of land in question adds to the product of the community over and above what could be produced without it—Carver; *The Distribution of wealth* pp 205-206.

tivated in the first instance; and for a certain outlay of labour and capital, the yield per acre on A grade land is 50 maunds. After some time, the second grade land is also brought under plough. For the same outlay, its return is, say, 45 maunds per acre. A surplus of $(50 - 45) = 5$ maunds begins to appear on A grade land. This is its economic rent.

After some time the population increases so much that even the third grade land comes up for cultivation and its yield per acre on the above outlay is, say, 35 maunds. Thus surplus produce of A grade land is now raised to $(50 - 35) = 15$ maunds; while B grade land also begins to show a surplus of $(45 - 35) = 10$ maunds, which is its rent.

In course of time, D grade land will also come under cultivation. Suppose, its yield is 20 maunds only. It will raise the surplus or economic rent of A grade land to $(50 - 20) = 30$ maunds; of B grade land, to $45 - 20 = 25$ maunds; and on C grade land rent will begin to appear to the extent of $(35 - 20) = 15$ maunds.

In the following diagram O A, A B, B C, and C D, are A grade, B grade, C grade and D grade lands respectively. The application of an equal outlay on each of them gives an yield represented by the rectangles standing just above the respective bases. C D is the no-rent land and does not yield any rent as its expenses of production (excluding rent) are just equal to the price of its produce. All the other plots yield economic rent equal to the shaded

portion of their respective rectangles.

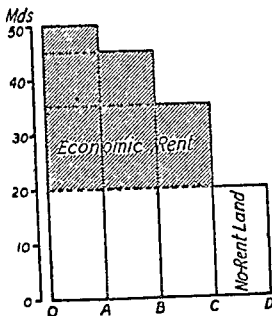


Figure showing the origin of rent.

Marginal or No-Rent Land

From the above discussion, it is plain that the no-rent or marginal land plays an important role in the determination of the economic rent. It is called No-Rent land because its expenses of production (excluding rent) are just equal to the price of its produce so that it cannot afford to pay rent. Being on the margin of cultivation, it is also called marginal land. The following important points must be remembered with regard to the marginal land :—

(1) It has a decisive influence on rent. Its yield forms the base from which economic rent on super-marginal land is calculated.

(2) Market price of the agricultural produce is equal to its cost of production on the marginal land. It could not be less than the cost of production; otherwise it will not be produced at all, the marginal land will remain idle. Nor could it be less

than the cost of production; otherwise a lower grade land will be brought under plough and the marginal land will become super-marginal land.

(3) Marginal land is not fixed. It is, on the other hand, very sensitive to variations in the price of agricultural produce. As soon as the market price goes up, the marginal land becomes super-marginal and the sub-marginal land becomes marginal. On the other hand, if price goes down, the marginal land goes out of cultivation, a super-marginal land becoming marginal.

The Intensive Form of the Theory of Rent

In the above discussion we have exposed the theory of rent as applied to land cultivated extensively. The theory is also applicable to the land cultivated intensively. When the land is intensively cultivated, the yield due to successive doses of labour and capital goes on diminishing till a stage is reached when the cost of the final dose is just equal to the price of the yield it gives rise to. This is the marginal or no-Rent dose. The produce due to all other doses exceeds that of the marginal dose. The surplus or the differential advantage thus appearing is the economic rent.

The diagram given on page 219 can also be used for explaining the intensive form of the theory of rent. Suppose, the yield due to the application of the first dose of labour and capital to a plot of land is 50 maunds; that due to second dose, 45 maunds; that due to the third dose 35 maunds; and that due to the fourth and final dose, 20 maunds. The rent in the case of first three doses is 30 maunds, 25 maunds and 15 maunds respectively. the fourth dose being no-rent dose.

! O A, A B, B C and C D represent the four doses and the rectangles standing over them represent the yield due to each of them. The shaded portions of the rectangles over O A, A B and B C represent the surplus or the economic rent. Note that no rent arises in case of the marginal dose, CD,

An important point that arises from this discussion is that rent will arise even if all the land was of uniform quality. In such a case, extensive form of cultivation will not, of course, give rise to rent, but if the pressure of population may necessitate intensive cultivation, rent will arise as shown above.

Criticism of the Theory¹⁰

Ricardian Theory of rent has been criticised on many grounds. The following are the main points of criticism :—

(1) Ricardo maintains that rent is paid for the "use of the *original and indestructible* powers of the soil". This expression is not very accurate. The powers of the soil, for which rent is paid, are not always original; in some cases they are acquired. Again fertility, which is one of the most important part of the soil, is destructible¹¹.

(2) His theory is said to be historically false. He said that the best land is first put under plough and later on land is picked up for cultivation on the merit of its goodness. It has been said against this contention that the order of cultivation is just the reverse; men proceed from inferior to superior land. But the contention of the critics is, in the first place not free from doubt. Even if it were correct, it must be realized that Ricardo's historical order of cultivation is not of the essence of his theory. It is simply an illustration, a method of putting a thing. What he wants to show by this historical illustration is that different plots of land differ in quality. And this, of course, is true.

(3) The most damning criticism against the Ricardian Theory is that it is thoroughly hypothetical and unrealistic. The assumption of free competition, on which the theory stands, is unreal; it does not

10. Also see Clay, *op. cit.*, pp. 360-363

11. Some economists defend Ricardo by stating that except fertility other qualities of land like climate, extent and conformation are certainly indestructible. This statement, though correct, does not take away the force of the criticism.

exist in practical life. And it makes the theory unrealistic too.

(4) Finally it is said that no-rent land does not always exist. If a country is very thickly populated, even the worst land might bring some rent. This is true to a certain extent. But if the market extends beyond the national boundary, no-rent land may exist in some other country supplying the same market. Even if we suppose for the sake of argument that No-rent land does not exist anywhere in the world, no rent *does* must exist somewhere. And if so, it may be said to determine rent. This criticism as such, is unfair.

The conclusion is that the purport and the principles underlying Ricardo's theorization are quite correct on assumption of perfect competition. The moment that assumption is taken away, his theory becomes inapplicable and it is the theory of contract rent which begins to apply.

§4. RENT AND PRICE OF AGRICULTURAL PRODUCE

The relation between rent and price has been a fond theme of economists. The question is often asked, whether the rent paid on land affects the price of agricultural produce or not; so that if rent is increased or decreased, whether the price will behave similarly as a consequence or not. The answer was given by Ricardo long ago. He showed that rent does not determine price; on the other hand, it is itself determined by price.

Rent Does Not Determine Price

The fact that rent does not determine price, becomes clear if we take into consideration two fundamental facts. (1) Firstly, the price of agricultural produce equals the expenses of production on the marginal land. If the price exceeds the expenses of production, even inferior land will be brought under plough and the existing marginal land will cease to be the marginal land. On the other hand, if the price is less than the expenses of production, the cultivation

of this land will become unprofitable and will, therefore, be given up. Thus it will, again, cease to be the marginal land. As such, *the price of agricultural produce must be equal to the expenses of production on marginal land*: it can neither be more or less. (2) secondly, the marginal land (or marginal dose) does not yield any rent because its produce is only just sufficient to cover the expenses of production (excluding rent). Evidently rent does not enter into the expenses of production on marginal land.

Summing up these two facts, we may say that the price of the agricultural produce equals the expenses of production on the marginal land, which does not include the item of rent. Obviously, rent could not exert any determining influence on the price of agricultural commodities.¹²

There is, however, an *unscientific* sense in which rent may be said to enter into price. We might say that rent enters into price inasmuch as it is paid by the cultivator of superior land *out of the price* which he gets for his product. But it does not enter into price in the sense, which is the correct and the scientific sense, that it determines the price, or that it is one of the elements of *cost* which determines the supply price of anything¹³.

Price Determines Rent

In fact, rent is itself determined by the price of agricultural produce. If the price of agricultural produce goes up, it becomes possible to cultivate a sub-marginal land; the margin of cultivation having gone down, rent increases as a matter of course. A fall in the price of agricultural produce creates an opposite effect. It makes the cultivation of the marginal land unprofitable with the result that a super-marginal land now becomes marginal land; by thus pushing up the

12. Rent has no influence on the value of the product. Prices are fixed by the expenses of production on the poorest land, where wages and interest are paid but no rent. Hence the rent that is paid for the better land is the result of the price fixed in this way and not a cause of it—Ely and Wicker, *Elementary Principles of Economics*, p. 263.

13. Thomas, *Elements of Economics*, p 251.

the margin of cultivation, it reduces rent. Rent in this way varies with the price of agricultural produce.

Effect of Rent Remissions on Price

Since rent does not affect the price of agricultural commodities, any reduction in it will fail to bring down prices. Even if rent is altogether remitted by landlords, the price of agricultural produce will remain unaltered. So long as the marginal land and the expenses of production on that land remain the same, price will also remain unchanged.

By the same reason, it can be easily shown that if rent is increased manifold, the price will remain the same. As Ricardo said : corn is not high because a rent is paid but a rent is paid because corn is high. A rent is not a component part of the price of commodities.

Exceptions : When Does Rent Enter into Price ?

There are, however, certain exceptional cases in which rent does enter into the price of agricultural produce. Ordinarily it does not enter into price because it is not an element in marginal expenses of production. In the following cases, rent does become an element of the marginal expenses and, therefore, enters into the price of the produce :—

(i) If a State, or a body of landlords, has a monopoly of land, it may charge rent even on the marginal land. If so rent will constitute a component item in the marginal expenses of production and will affect price. In India, it is said, the State, which enjoys the monopoly of landownership, charges rent even on no-rent land; therefore, rent enters into price of agricultural produce in India.

(2) Where cultivators have no other occupation except agriculture, competition amongst them becomes so keen as to make them pay rent even on the marginal land. Here, again, rent enters into price. This is the case in India.

(3) When a land which is super-marginal with reference to one crop, is devoted to another crop with reference to which it becomes marginal, the old rent continues to be paid. For instance, a plot of land may be super-marginal and productive of rent when devoted to wheat; but if it is now given to the production of, say, barley, it may become marginal and incapable of yielding any rent. Still the old rent will be charged. Here, then, rent will enter into marginal expenses of production and, therefore, in price¹⁴.

§ 5. FACTORS EFFECTING RENT

We have seen that price determines rent. Consequently, all those factors which affect the price of agricultural commodities necessarily influence rent. Improved transport, agricultural improvements, increase in population and general advance in civilization, are the most important of them.

Effect of Improved Transport

Improvement in the means of transport affects agricultural prices and the rent of a particular land according to the nature of the tract with which it is now connected, for the first time or with greater facilities than before.

(a) If the new tract, made accessible by the improved means of transport, offers comparatively high prices for agricultural produce, rent will tend to increase. For instance, the revolution in the means

14 I personally think that these exceptions are out of the point. Here we are talking about economic rent, which is inextricably linked up with free competition and under free competition economic rent cannot enter into price. If there is free competition, monopoly of land is out of the question. Again, absence of alternative occupations to cultivators, which increases competition amongst cultivators *inter se*, reduces their competitive strength against landlords, and is therefore, incompatible with free competition. As regards the last exception of the devotion of land from a more profitable to a less profitable crop, it need only be said that it is a sad estimation of human intelligence: why should anybody, with a brain, do it? If these exceptions are meant to be applied to the contract rent, the whole discussion, as a part of economic rent theorization and its foundation on marginal land and marginal expenses of production becomes absurd.

of transport during the 19th century enabled the American farmers to send wheat to England where it was sold at fairly high prices. In America the demand for land went up, sub-marginal lands became marginal lands in quick succession; and rents increased by leaps and bounds.

(b) If the new tract of land made accessible by improved means of transport, is a new source of supply of cheap agricultural commodities, rent will tend to fall. For instance, when America began to supply wheat to England in the 19th century at cheap prices, much land in England went out of cultivation; super-marginal lands became marginal, and then sub-marginal in quick succession; and rents decreased.

Effect of Agricultural Improvements

Improved methods of cultivation lead to the production of increased quantity of produce from the total land under cultivation. The demand for agricultural commodity remaining unaltered, their price will obviously shrink. The marginal land will go out of cultivation: it will become sub-marginal; and rents in general will fall. Rent arises as a result of the operation of the law of diminishing returns and, other things being equal, any factor retarding its operation, as is the case with agricultural improvements, lowers the rents. If, however, the demand for agricultural produce goes up, consequent upon a fall in the price of agricultural commodities, the shrinkage in rent may eventually be restored.

We cannot, in fact be very definite about the effect of agricultural improvements on rent. Some economists hold the view that these improvements benefit poor land more than the rich: the latter already yield fairly heavy crops so that there is little incentive to increase their produce further; while the low yield of the poor land constantly offers this incentive. As such, agricultural improvements generally increase the output of poor lands and tend to level the productiveness of the soil of different grades. If this point of view is correct, rent will tend to fall. In fact, "the

irregularity of the applications of improvement causes varying effects on rent, and all that we can do is to indicate broad tendencies¹⁵."

Effect of Increase in Population

An increase in population raises rent. Increased population means greater demand for agricultural produce, which can be satisfied by forcing down the extensive or intensive margin of cultivation; in other words, by cultivating a hitherto sub-marginal land or by applying more doses of labour and capital to the existing cultivated land. In any case, the surplus, or differential advantage of super-marginal lands, will increase and rents will go up. Moreover, as population increases, land will be required for such non-agricultural purposes as the construction of houses and factory-buildings, bazars and streets, etc. The rental value of land will rise due to this factor as well.

Effect of an Advance in Civilization

The consequences of an advance in civilization are similar to those of an increase in population, namely, rent tends to rise because (1) the improved standard of living requires more expensive varieties of food and clothing, thus increasing the demand for agricultural land; and (2) the demand for land for non-agricultural purposes like parks, play-grounds etc., also goes up. Rent rises as a consequence.

§ 6. RENT OF BUILDING SITES, MINES AND FISHERIES

Rent of Building Sites

The rent of building sites is determined on the same principles on which the rent of agricultural land is determined. It may, however, be noted that the rent of the agricultural land depends upon its fertility and location; but in the case of building sites, location alone is important. In the case of buildings for residential purposes, situational advantage consists in the natural beauty, fashionableness, healthfulness, and conveniences of the site in question. The goodness of the site for buildings for business purposes depends upon its attrac-

15. Thomas, *Elements of Economics*, p. 256.

tiveness, frequency and number of customers passing before it, the adjoining shops etc. Thus, the rent of building sites, whether for residential or business purposes, is always the *situational rent*.

But this difference does not alter the principle by which the rent is determined. At any particular time there is in existence a no-rent waste land which is useless for building purposes. There are many other sites distinctly superior to it for building purposes. The differential situational advantage of the super-marginal building sites over the marginal one, is the measure of rent. Rent of building sites is highest in the heart of the city and goes on diminishing as the distance from the centre increases.

Rent of Mines And Quarries

The total payment made for a mine in the shape of rent consists of two parts : (1) Payments made for the minerals removed which are not replaced, called *Royalty*. In agricultural land, it may be noted, no such payment is made for the fertility of the soil which, if properly used, is inexhaustible (2) *Rent Proper*, which is paid for differential advantages in respect of ease of working and convenience of situation, called *Mine Rent*.

Royalty has no semblance to agricultural rent; it is, however, the mine rent which resembles it so closely inasmuch as the margin may be lowered *extensively* by the working of less convenient or inferior mines and *intensively* by the application of more costly methods in the superior mines¹⁶. At any particular time there is a marginal or no-rent mine which is so difficult to be worked and so inconveniently situated that it pays no mine rent. All other super-marginal mines pay rent equal to the differential advantage¹⁷.

16. Thomas, *op. cit.*, p. 252.

17. This is Marshall's view. It is difficult to agree with him that royalty is not analogous to agricultural rent. Fertility, unless replaced by certain methods, is definitely exhaustible. And if so, the analogy between agricultural rent and gross rent of mine is complete. Taussig's unwillingness to accept Marshall's view that even the poorest mine will yield some return to the owner of the mine for the minerals removed, seems to be just from the point of view of theory.

Rent of Fisheries

It is maintained by many economists that with proper care fisheries yield a perpetual return, as happens in the case of agricultural lands. As such, the analogy between agricultural land and fisheries is perfect and rent of fisheries is determined in the same way as that of agricultural land. No-rent fisheries yield no rent; the differential advantage of all the super-marginal fisheries measures the rent.

§ 7. UNEARNED INCREMENT

The value of land increases if the landlord effects substantial improvements in it. Sometimes, the value goes up due to the operation of certain social factors and without any effort on the part of the landlord. For instance, if the town grows up around a plot of land or if it is connected with the surrounding areas by efficient means of transport and communication, the value of land is bound to increase. Such increase in value due to the operation of certain social factors and without any effort on the part of landlord is known as *unearned increment*.

Unearned increment is not the fruit of the labour of the landowner; it is the consequence of certain social causes. As such, it should not be allowed to be enjoyed by the landlord but should be spent for the welfare of the society as a whole through the agency of the State; the Government may take away this increment—

(1) *Through taxation.* An unearned increment in value may be lopped off by the Government by the imposition of a tax; or

(2) *Through land nationalization.* The entire land may be nationalized, i.e., put in the possession of the State so that any unearned increment appearing on the land might automatically benefit State finances. This opinion is held by many economists and is very much advocated by socialists of all shades of opinion.

CHAPTER IV

RENT IN INDIA

Whilst the majority of the Indian cultivators may indeed find it necessary to adhere to the native principles of continuous tenancy, a Government such as ours in India, should offer every facility for changing the tenure to freehold both because it can be done without loss of revenue and when done and in the process of doing, that change would enlist the willing help of the most numerous and most industrious classes in improving the yield of the land and unite their interest with that of the rulers through whom their possession would be assured.—*James Caird*.

§ 1. APPLICABILITY OF THE RICARDIAN THEORY TO INDIA

The applicability of the Ricardian Theory of Rent to India is sometimes questioned. Indeed, there is a class of Indian economists who appear to believe that the Ricardian theory does not apply to India. The rent paid by the tenants to their landlords, they say, is not equal to the economic rent as envisaged by Ricardo in his theory; more often than not, it exceeds economic rent because of severe competition amongst cultivators and absence of alternative occupations. Therefore, they conclude, that his theory is inapplicable to India.

This reasoning is ill-conceived and fallacious *ab initio*. Ricardo simply said that the economic rent of a particular land is equal to the excess of its yield over that of the marginal land; and that, under free competition, it will go to the landlords. Now in India there must be some no-rent land. Other super-marginal lands under plough must be yielding heavier produce than the marginal land. Well, then, this excess of produce is the economic rent of the super-marginal land. How is the Ricardian Theory inapplicable to Indian conditions? Were free competition to prevail, which is not actually the case, this excess must go to the landlord¹. If the actual, or

1. As a matter of fact, Ricardo's theory is universal truth and applies to all the countries of the world with equal force.

contract rent exceeds economic rent in India, it is due to the fact that free competition does not exist. But such a case falls outside the scope of the Ricardian Theory. The assumption is to theory what foundation is to building; if the base of either is removed, vicious results are liable to follow.

§ 2. DETERMINATION OF CONTRACT RENT IN INDIA

Contract rent is, of course, determined in India by demand and supply. In the interaction of these forces *custom, competition, legislation and absence of alternative occupations* play prominent parts.

In olden days land was abundant in our country and rents were fairly low. Those were the days of common brotherhood and fellow-feeling; and the bonds of unity were strengthened by the common danger of robbers and thieves. The relationship between landlords and tenants was marked with extreme cordiality, crystallised in wholesome *customs* handed down from one generation to the other.

With the advent of the British rule in India, peace was restored in the country. Economic development went on at a rapid pace. Demand for land increased and landlords began to increase rents beyond the customary limit. In other words, *competition* began to assert itself. The import of individualism along with other western ideals accentuated competition and partially broke down the traditional customs.

The British rule in India also wrote the death sentence of our handicrafts of diverse types. Having thus *lost alternative occupations*, cultivators began to depend entirely on agriculture. Competition amongst agriculturists increased all the more. They began to pay more than economic rent since they preferred the pursuit of agriculture and semi-starvation, to its renunciation and complete starvation.

This sort of rack-renting gravely injured the already delicate economic position of the cultivators

Besides, it checked agricultural improvements; when agriculturists found that an increase in the yield of land as a result of agricultural improvements is unjustly snatched away by landlords, they stopped to spend money, time and energy on the betterment of land and methods of cultivation. To remedy this state of affairs, Government came forward with *tenancy legislation* which aims at guaranteeing fixity of tenure and fairness of rents.

At the present moment, custom, competition, absence of alternative occupations and tenancy legislation, exert influence in the determination of the contract rent. Customs are still alive, competition is still in the embryo, while alternative occupations are still lacking; hence tenancy legislation is not wholly effective.

§ 3. LAND TENURES IN INDIA

Land Tenures

Three parties are usually connected with land: the *State*, which is the *supreme Landlord*, the ultimate owner of all land; *landlords*, who have acquired certain specific rights in land and who hold land on certain agreed terms from the State; and *the actual cultivators* who till the soil and take it from the landlords². The term "land tenure," which is derived from a latin word meaning "to hold", is used to refer to the terms and conditions on which land is held from the Government. Broadly conceived, land tenure refers to the rules and regulations under which one party holds land from the other. In the latter sense, it is divisible into (a) *proprietary tenure*, i.e., the terms and conditions on which landlords hold land from the State, and (b) *cultivating tenures*, i.e., terms and conditions on which land is held by cultivators from the landlords³.

The Ideal Land Tenure

The characteristics of an ideal land tenure are two: (1) Fair Rents. Rents should be fair. If rents are unfair,

2. Sometimes cultivators hold land directly from the State as under the Ryotwari system in India.

3. Or from the State, as in Ryotwari tracts.

cultivators will be exploited and agricultural improvements hindered (2) fixity of Tenure. The cultivator must be sure that the period of his stay on land will be fairly long. Otherwise he will not effect permanent improvements on it lest he might be ejected before he could enjoy the fruits of his investment. Not only this; he might even use the land with undue tyranny so as to take the most out of it during his stay, thus making it unfertile within a short time. Our land tenure had long fallen short of this ideal. Recently the State has tried to remedy this defect through Tenancy Legislation.

Land Tenures in India

We shall now discuss land tenures in our country. We shall confine our attention to proprietary land tenures only and not to cultivating land tenures which are too wieldy to be interesting or useful to the beginner. The following are the important kinds of proprietary land tenures in India :

(1) *The Zamindari Tenure*—Under this tenure one landlord is made responsible for the payment of the land revenue on the whole estate. The settlement may be fixed once for all, when it is known as *Permanent Settlement*; for instance, in Bengal, Behar and Northern districts of Madras and Benares division of the United Provinces, the Settlement is permanent and the land revenue payable by the landlord to the State has been fixed once for all. In the alternative, the settlement may be only temporary, subject to revision after a fixed period, when it is called *Temporary Settlement*. Settlements are temporary in such zamindari estates in Bengal which are not under permanent settlement. Settlement with the taluqdars of Oudh are also temporary.

(2) *The Mahalwari or Joint Village Tenure*—According to this system, Government enters into contract with the co-sharers of an estate, who become jointly and severally liable for the land revenue. As a matter of fact, the agreement is entered into with the

Lambardar or Malguzar who is the representative of the villagers and who becomes directly responsible for the payment. This system is prevalent mostly in northern India. The settlements under this system are temporary.

(3) *The Ryotwari Tenure*—Under this system the cultivator takes rent directly from the State and pays land revenue straight to the State coffers. No landlord, or middleman, between a cultivator and the State is recognised. This system is mostly prevalent in Southern India, particularly in Bombay, Madras and Berar. It does not exist in the United Provinces.

Settlements

By settlement of land revenue we mean the determination of the amount of land revenue, the person or persons liable to pay it and the record of all the private rights and interests in the land. Settlements can be divided according to the duration. Where the land revenue is fixed in perpetuity it is called Permanent Settlement; and where it is fixed temporarily, it is called Temporary Settlement. In India most of the tracts under zamindari system in Bengal, North Madras and Benares Division are permanently settled. In the rest of India, temporary settlement is in vogue.

Permanent settlement was introduced by Lord Cornwallis in 1795, when the difficulties in the collection of land revenue were enormous and the permanent nature of the settlement was a great convenience. But it was soon discovered that zamindars extract as much as they can from the cultivators, but pay only a fixed fraction of their booty to the State. In this way, it inflicted a loss of revenue on the State⁴ and

4. According to the Bengal Land Revenue Commission, 1940, "the annual loss in this generation resulting from the enactment of the Permanent Settlement may be estimated at anything between 2 crores and 8 crores." (See Chapter II)

For a thorough and up-to-date discussion of the introduction, financial, administrative, social and economic results, and the suggested improvements in the system of Permanent Settlement. See *Bengal Land Revenue Commission Report, 1940*.

unduly exploited agriculturists. Therefore, it was not spread over other parts of the country.

§ 4. LAND TENURES IN THE UNITED PROVINCES

We shall now study the land tenures in the United Provinces.

PROPRIETARY TENURES

Of the three types of proprietary land tenures discussed above, the zamindari and mahalwari or joint village tenures are found in the United Provinces.

The Zamindari Tenure

The zamindari tenure in the United Provinces exists in two shapes: (1) the Permanent Settlement with the zamindars of the Benares Division and (2) Temporary Settlements with the Taluqdars of Oudh. The Benares Division is the only tract in the United Provinces having permanent settlement. In 1785, the British were keen on extending Bengal model of Permanent Settlement and were not familiar with the peculiar system of joint tenure of land in force in the Benares Division at that time. Therefore, they dealt with one of the chief co-sharers or some other prominent person on a permanent settlement basis.

In the province of Oudh, Government enters into agreement with the taluqdars or chiefs for the payment of land revenue on a temporary basis. The Government takes from the taluqdars the sums collected as rent revenue after having the cost of collection and a certain sum for the maintenance of taluqdars according to the pleasure of the Government. The settlement takes place for a period of thirty years. The taluqdar differs from the landlord under permanent settlement inasmuch as the settlement with him is only temporary and he has no absolute right over his estate.

Mahalwari or Joint Village Tenure

Almost the entire province of Agra is under Mahalwari or joint village tenure. The Government enters into an agreement with the co-sharers of an estate or village, by which the latter may become liable, jointly and severally, for the payment of land revenue. Usually the *lambardar* or *malguzar* enters into the agreement on behalf of the villagers. The settlement is revised after 20 or 30 years. Nearly half of the net assest are taken away by the Government in the shape of land revenue.

CULTIVATING TENURES

After having discussed the terms and conditions on which the middlemen hold land from the Government, we now come to the description of the terms and conditions on which actual cultivators hold land from the middlemen. From this point of view, tenants can be divided into (1) permanent tenure holders, (2) fixed rate tenants, (3) ex-proprietary tenants, (4) occupancy tenants, (5) statutory tenants, and (6) tenants-at-will.

(1) *Permanent Tenure Holders*—Their rights and privileges are similar to those of zamindars. Their rights are heritable and transferable; they can sell and mortgage their property. They are found in the permanently settled area and the amount of rent revenue to be paid to the State is fixed once for all.

(2) *Fixed Rate Tenants*—They resemble permanent tenure holders as they are also found in permanently settled tracts, their rights are heritable and transferable and the rate of rent to be paid by them is fixed in perpetuity. Their special feature is that if the land held by them increases or decreases, the land revenue payable by them increases or decrease proportionately.

(3) *Ex-proprietary Tenants*—There are certain landlords who, faced by financial stringency, had sold away their zamindari but have been cultivating their *Sir* land, i.e., the land which they used to cultivate

while they were zamindars. They are known as exproprietary tenants because of their acquiring exproprietary rights in the *Sir* which is heritable but not transferable. Exproprietary tenants hold the *Sir* land at reduced rent.

The above three types of tenants enjoy enviable privileges and rights. In the first two cases, the rent is fixed for ever and though the economic rent has mounted up, their commitment has remained unaltered. In the latter case, the concession of reduced rent, which comes to 25 per cent. of the usual and actual rent, is also considerable.

(4) *Occupancy Tenants*—Cultivators who cultivate the same plot of land continuously for a period of twelve years acquire fixity of tenure in that land. They are known as occupancy tenants and cannot be ejected from the land. Their right is heritable but not transferable. Their rents cannot be increased unless it be by mutual consent or by the order of the court. The enhancement cannot exceed one anna in the rupee and can be made only once in ten years.

(5) *Statutory Tenants*—The Agra Tenancy Act, of 1927 has created what are called, statutory tenants. According to this Act, all the cultivators who have cultivated a piece of land for one full year cannot be ejected from the land so long as they live, provided they pay the rent regularly. The rent cannot be increased within a specified period and without sufficient ground. Their successors inherit the right of cultivating the land for five years after their death.

(6) *Tenants-at-Will*—They have no right on land and can be ejected at the sweet will of the zamindar. The Agra Tenancy Act, 1927, aimed at converting them into statutory tenants but the object of the Act has been defeated by the tactics of zamindars. They do not allow cultivators to cultivate a land for one full year, unless he agrees to renounce the statutory rights that he acquires on the land. Their condition is very poor.

In Oudh tenants do not possess as much rights and privileges as the tenants of Agra Province do. The taluqdars of Oudh have a higher status than the zamindars of Agra and their hold over their tenants is very strict. Many times they have successfully resisted the attempts to increase the rights and privileges of the cultivators.

In Kumaun Division, the cultivators, called *padhans*, are practically peasant proprietors. They pay land revenue to the Government directly. The land has been created by the cultivators themselves by terracing or levelling the hilly tracts and they are its owner.

CHAPTER V

WAGES

It is not to be understood that the natural price of labour estimated in food and necessities is absolutely fixed and constant. It essentially depends on the habits and customs of the people—*Ricardo*.

§ 1. INTRODUCTION

Meaning of Wages

A wage is a price; it is the price paid by the employer to the worker on account of labour performed¹. It may, as such, be defined as the price paid by an entrepreneur to the labourers employed for productive purposes. It is the share of the national dividend which accrues to labour in the broad sense of the term, including all kinds of workers whether they receive salaries, pays, or wages; whether they are paid annually, monthly, weekly or daily; whether they are skilled or unskilled; whether their work is manual or mental².

There are two doubtful categories of labourers whose remuneration is called wages by some and excluded from this class of income by others. The first is the case of those entrepreneurs, who take part in superintendence and management of the venture. In so far as they themselves superintend and manage the business, they work as organisers and are entitled to a salary. If they do not themselves do this work,

1. See J. R. Turner, *Introduction to Economics* p. 440.

2. Labour is a wealth creating effort (J. B. Clark, *Essentials of Economic Theory*, p. 9) Any human exertion directed primarily toward the creation of utility, is labour. Although the work of a child at school may create "productive power", the immediate end not being production, it is not economic labour. "The remuneration of labour" (Seligman, *Principles of Economics*, p. 411), "the earnings assigned to men for their work" (Seager, *Introduction to Economics*, p. 222), in other words, the recompense of human exertion in the production of utility is wages—F. H. Streightoff, *The Distributions of Incomes in the United States*.

they will have to employ an organiser and pay him a reward. Therefore, any payment made to them, directly or indirectly, is obviously of the nature of wages. The second class is constituted by independent workers like teachers, doctors, and lawyers. They undergo some physical or mental exertion and receive a reward for their labour, usually called fee. Some economists are of the opinion that this remuneration should be put under wages. This opinion is not quite correct because the services rendered by these persons are sold to consumers directly, and not to producers as is the case with labour. This reward is usually classed under profits and falls outside the scope of wages.

Wages, Pays and Salaries

The remuneration given to labourers is known by different names according to their status and the time of its payment. The remuneration paid daily or weekly is called *wage*; that paid monthly is known as *pay*, while that paid yearly is called *salary*³. There is no technical difference in the nature of wages, pays and salaries, all being the earnings of labourers. But from the point of view of social status and prestige of labourers, this distinction is very important. Wages are usually given to ordinary, unskilled labourers who live from hand to mouth and who belong to the lower status of society. Pay is given to middle class persons like teachers, clerks and ordinary officials who hold a higher social status than the wage-earners. Salaries are given to high Government dignitaries and well-paid organizers who constitute the richest section of the society. Wages are less than pays and pays are less than salaries. The differences in these incomes are wide in the present-day capitalistic economy. The wideness of the differences has given rise to much hard thinking and a movement aiming at an equalization of incomes

3. See Benham, *Economics*, page 17; Batson, *Practical Economics*, p. 48. In this context the term wages has been used in the narrow sense. In the broad sense, in which it is generally used, it includes all the three types of remuneration mentioned here.

as much as possible, has been started under the name of Socialism².



Figure showing differences in incomes.

The Problem of Wages

Of all the branches of Economics, Distribution is the most difficult and the most important section; and of all the problems of Distribution, the problem of wages is the most difficult and the most important problem. It is the most difficult because labour being inseparable from labourer, the human element enters into consideration more definitely at this stage than in any other phase of our enquiry; and the interference of non-economic elements with the operation of the economic ones has always to be faced with. It is the most important section of our investigation

4. The question of inequality of incomes is very important and may be studied from a number of elementary books like Clay, *Economics for the General Reader*, Batson, *Practical Economics*, etc..

The following is an explanation of the inequality of wages : Wages depend on productivity, and productivity depends on ability, training and equipment in the widest sense. Ability varies, training is too expensive for the poorest workers, so that the difference between skilled and unskilled wages is not wiped out by a flow of labour from unskilled to skilled occupations; and the comparative efficiency of equipment as between different industries is constantly varying, while mobility between industries and places is checked by ignorance, inertia, and the fear of losing the advantages of specialized skill—Scott, *The Approach to Economics*, pp. 125-130.

because it concerns the class of society which has the greatest numerical strength and which, generally speaking, is most dissatisfied with the present-day economic organization of society.

§ 2. DETERMINATION OF WAGES

Wage, we have said, is the price of labour. We have now to discuss how the price of labour is determined. The price of an ordinary commodity is determined by the formula of demand and supply. If labour be regarded as a commodity, the same theory of value will apply to wages as well. But labour differs from an ordinary commodity in several respects which necessitate a modification in the theory of value when applied to wages.

Peculiarities of Labour

The following are the peculiarities of labour as a factor of production :—

(1) *Labour cannot be separated from the labourer.* The labourer has, therefore, to present himself at the place where labour is required. This is not the case with other commodities. Land can be separated from the landlord; capital, from the capitalist; commodities, from the trader. Due to the inseparability of labourers from labour, various personal factors affecting the former have to be considered when discussing wages a fact which makes the problem of wages a hard nut to crack. For instance, labour is not so mobile as, say, capital because its mobility depends upon the mobility of the labourer, which is hindered by a long list of personal considerations. These personal obstacles are, of course, absent in the case of other factors of production.

(2) *Labour power is the most perishable commodity.* If a merchant does not sell his commodity today, he hopes to be able to sell it tomorrow. But if a labourer does not work on any particular day, the labour power of that day perishes for ever and cannot be regained. Due to this fact, labourers prefer to sell their labour power at any price rather than

wait and let it perish irrevocably. The consequence is that wages are usually less than what they should be.

(3) *The supply of labour increases and decreases very slowly.* If the demand for an ordinary commodity increases, its price rises and it begins to be produced in increasing quantity. This is not so with labour. If the demand for any particular type of labour increases, its supply can increase in the following two ways : (a) Parents may train their children for that work. This will take considerable time and the supply will increase only slowly. (b) Labourers from other channels may be attracted towards this line by the offer of high wages. This latter alternative is not free from difficulties. The mobility of labour is a difficult process and cannot be relied upon as a quick measure. Moreover, the mobility might only shift the problem of the scarcity of labour from one grade or industry to another grade or industry.

What is true of an increase in the supply of labour is also true of a decrease in its supply. Labour of any particular grade or industry can decrease through natural death of labourers, or its mobility to other grades or industry. The first one takes time and the second one is unreliable, besides being slow.

We conclude, therefore, that the supply of labour adjusts itself to changes in demand only with difficulty.

(4) *The bargaining capacity of labourers is weaker than that of employers.* The rate of wages is determined by the bargain made between the employer and the labourer. Each is *supposed* to have perfectly free powers to consult his own economic interest, though as a matter of fact nearly always in the course of the world's history the Master has had the advantage and the Workman has been less free to strike his bargain. This is due to a variety of reasons : (a) Labour power, as we have seen, is perishable. The labourer prefers to sell his labour power for any price whatsoever rather than to remain idle and lose it for ever. (b) Labourers are generally poor and

have no resources to fall back upon, if they like to wait in the higgling and bargaining with the employers. They live from hand to mouth; and in order to earn their bread for tomorrow, they must work today at any remuneration whatsoever. Employers know it thoroughly well and make its unscrupulous use to their own advantage. (c) In the olden days if labourers could not get an employment, they could themselves produce goods and sell them in the market. But most of these handicrafts have now decayed in face of the competition of factory goods. The bargaining capacity of labourers has been considerably weakened. (d) Labourers lack organization. Trade unions, such as they are, are little developed, include only skilled labourers, and suffer from many defects and obstacles. Hence they do not always offer an effective resistance against the exploitation of employers. (e) Sometimes wages are paid according to some old established custom and are fairly low. Since custom does not easily change, wages do not easily increase. (f) Even if there are chances of getting high wages at some particular place or any particular occupation, labourers do not get the information. Their ignorance is a great obstacle in the way of high wages. (g) Finally, a rapid rise of population is creating a class of the unemployed of increasing dimensions, which is a fruitful cause of low wages.

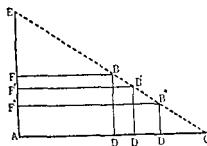
The Theory of Wages

The modern theory of wages is substantially the same as the theory of value, subject to certain reservations necessitated by the peculiar characteristics of labour discussed above. According to this theory, wages are determined by the inter-action of the forces of the demand for labour and its supply⁵.

5. "The explanation of price by Supply and Demand also holds good for labour, which is certainly a commodity although it is supplied and sold in a special way. The price of labour is not, of course, the same thing as the earnings of labourers. A person's earnings depend partly on the price of his labour and partly on the quality of it that he sells".—Batson, *Practical Economics*, p. 27.

Demand For Labour—The demand for labour comes from the employers who engages labourers for producing goods. The contribution of a worker to the net product is known as his *productivity* and may be expressed in terms of money. The productivity of the last or final or marginal labourer employed at any particular time is known as *final* or *marginal productivity*. Ordinarily, an employer goes on employing more and more labourers so long as he finds that the productivity of each additional labourer is greater than the wages he is given. But as the number of labourers increases, the productivity of each successive labourer goes on decreasing; just as the utility of each successive unit of a commodity goes on diminishing with the increase of its supply, other things remaining the same⁶. Ultimately a point is reached where the productivity of the last or the marginal labourer is just equal to the wages he is paid. Such a worker is on the margin of employment or dismissal—the employer is indifferent whether he is employed or not employed; anyway, he would be the last

6. The following diagram illustrates the working of the law of marginal productivity as applied to labour



Let the amount of labour be measured along the horizontal line AC and let the productivity of labour be measured along the vertical line AE, and let the descending line EC represent the rate of decrease in the marginal productivity of labour. If the amount of labour were measured by AD, the marginal productivity would be measured by BD or AF. If the amount of labour were measured by AD', the marginal productivity would be measured B'D' or AF'. And when the amount of labour equals AD'', marginal productivity is B''D'' or AF''. If labour increases to AC, marginal productivity would fall to zero.

worker employed by him. This labourer is, therefore, called the *marginal* or *final* labourer and his productivity *marginal productivity*.

Now, when we are considering a great body of labourers, we assume that all the members of the group are equally efficient and each is interchangeable with the other. Consequently, the same wage is paid to each of them. This will be the wage paid to the marginal labourer, which is equal to the marginal productivity. The employer will not pay more than the marginal productivity ; it is the buyer's maximum.

The Supply of Labourers—Just as the buyer has his maximum limit, the seller has his minimum limit, any offer below which is unacceptable to him. The labourer's minimum limit is set by his standard of living, i.e., the amount of necessities, comforts and luxuries which he has become accustomed to enjoy and which he will insist upon having. Wages must at least be equal to the cost of this standard of living. Generally speaking, the higher the standard of living the greater is the persistence shown in maintaining it. If lower wages are offered, the standard is sought to be maintained by such methods as deliberate postponement of marriage or life-long celibacy, mobility to other trades or localities where higher wages are obtainable, acquisition of greater efficiency or combination of workers and refusal to work at all except at adequate wages as determined by their standard of living. The standard of living of the worker thus sets the minimum limit below which wages cannot fall⁷. The standard wage, which the worker tries to maintain by reference to the social need of his class, is sometimes called the *social wage*.

Inter-action of Demand and Supply—Between these

7. The standard of life in the case of labour replaces the expenses of production in the case of ordinary commodities, but it will be appreciated that the standard of life is in many respects analogous to the cost of production of a commodity, because the standard of life is a measurement of sacrifice made by the worker in order to bring up the family, i.e., in order to increase the future supply of workers—Thomas, *Elements of Economics*, p. 277.

two limits, the maximum limit as set by the marginal productivity of labour, and the minimum limit as set by the standard of living of workers, wages are determined by the relative bargaining strength of labourers and employers. In actual practice, the bargaining strength of a labourer is very weak. Wages, therefore, tend to approximate the standard of living rather than the marginal productivity^s.

Old Theories of Wages

The above theory of wages is known as the Modern Theory or the Demand and Supply Theory of Wages. Economists in the past had propounded a number of theories of wages, the most important of which are (1) the Subsistence Theory or the Iron Law of Wages; (2) the Wages Fund Theory; (3) the Residual Claimant Theory and (4) the Marginal Productivity Theory. All these theories have now been discarded and the modern theory claims the largest number of adherence. But even this theory is not free from defects and we have yet to wait for an economist who can solve this riddle.

§3. WAGES, EFFICIENCY AND STANDARD OF LIVING Bet

Wages and standard of living are closely connected with each other and act and react upon one another through the medium of the efficiency of labourers.

Let us begin with *the standard of living*. Suppose the standard of living of workers goes up. They will now be able to satisfy their wants more richly, both quantitatively and qualitatively. Their efficiency, physical and intellectual, will increase. An increase

8. In the case of an ordinary commodity, the long period price approximates expenses of production; and short period price, the marginal utility. Similarly, some economists assert that wages tend to approximate, *standard of living in the short period and marginal productivity in the long period*. This view appears to me far from accurate. In the case of a commodity, there is the assumption that the bargaining strength of both the parties is equal. But such an assumption will be out of place in the case of labour. Hence the analogy pursued by the advocates of the above view is an unwarranted stretch of imagination.

in efficiency necessarily means an increase in productivity. The maximum limit up to which wages can go will thus increase. Again, standard of living determines the minimum below which wages cannot go. As such, a rise in standard of living also implies an increase in the minimum rate of wages. The maximum and minimum limits having thus gone up, wages are likely to increase.

If the standard of living goes down, opposite results will follow. Efficiency of labourers will go down. Their productivity will decrease. The maximum limit up to which wages can rise, will go down. The minimum limit up to which wages can fall will also decrease since it is the standard of living which determines this minimum, other things remaining the same. When the maximum and minimum limits are pushed down, wages are likely to be depressed.

Let us now look at the relationship *from the standpoint of wages*. If wages go up, labourers will be able to satisfy their wants more richly and their efficiency will rise. Their productivity will also increase. The maximum limit of wages will thus go up. At the same time, higher wages imply higher standard of living which pushes up the minimum limit of wages. The minimum and maximum having thus increased, wages are sure to spring up.

If wages fall, opposite results will follow. Efficiency will go down; productivity will fall as a consequence. Maximum limit of wages will thus be pulled down. At the same time, standard of living will decrease and the minimum limit will be depressed. Wages will therefore, fall.

We shall now consider the case *from the point of view of efficiency*. If somehow labourers increase their efficiency, their productivity will go up. Their wages will rise as a consequence. And they will increase their standard of living. The results following in the case of a fall in the efficiency are just the reverse.

From the above discussion two conclusions emerge. Firstly, labourers can increase their standard

of living or make themselves more efficient, other things remaining the same. Secondly, the influence of a change in standard of living, or efficiency, or wages, is cumulative. If, say, efficiency increases, wages will increase. They will push up the standard of living. It, in its turn, will increase efficiency. The circle thus got going will continue to move⁹.



Figure showing the relationship between standard of living, efficiency and wages.

§ 4. THE REAL AND NOMINAL WAGES

Meaning

In the modern times, labourers are generally paid in money. Wages paid in terms of money are known as *Money or Nominal Wages*¹⁰.

The labourer does not value money for its own sake. What is of *real* importance to him are the necessities, comforts and luxuries which he can purchase with the money wages he receives. Again, he

9. See A. C. Pigou, *Economics of welfare*

It has been assumed in this discussion that the expenditure of the labourer will be wise. If wages increase the standard of living and with it the efficiency, it has been assumed, will go up. It is true that at times labourers indulge in foolish expenditure as well. The best way to check it is (1) to increase wages in some veiled form, as for example, giving them A quality wheat at the price of B quality, or (2) to make this increment very gradual this increase should of course be accompanied with a propaganda in favour of wise expenditure.

10. Some writers define money wages as wages *expressed* in terms of money. This language is faulty leading to fallacious concept. If the entire real wages are evaluated or expressed in money, they will not probably be called money wages. The point is debatable anyway.

also attaches substantial importance to other kinds of payments, concessions and incidental advantages which he gets in addition to money wages. For instance, a domestic servant may get free lodging, old clothes and shoes, *inam* on festivals and free trips with his master. A mill worker may similarly obtain mill products at concession rates, free reading room, free games etc. *The necessities, comforts and luxuries which can be purchased with the money wages, or other kinds of payment, together with concessions and advantages incidental to the service, constitute the real wages¹¹.*

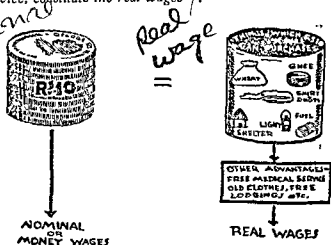


Figure illustrating nominal and real wages.

Labourers are not so much concerned with the money wage as with real wage. Wages in a village may be only Rs. 5 per month and those in a town, Rs. 7 per month; but the prices in the town may be much higher than those in villages, so that the real wages in the village may be higher than those in the town. When a labourer has to choose between two services, he takes into account, not the money wages, but the real wages. It is, therefore,

11. Money wages refer to the content of the pay-envelope, to the number of dollars the wage-earner receives. By real wages is meant not the number of dollars, but the amount of purchasing power received.—J. R. Turner, *Introduction to Economics*, p. 453.

important to know what considerations enable us to assess the real wages.

Factors Effecting Real Wages

(1) *The Purchasing Power of Money*—The most important factor determining real wages is the purchasing power of money. At some place general prices are very low so that the purchasing power of money is fairly high; at others, on the contrary, prices are very high so that the purchasing power of money is very low. If the wages are, more or less, the same at all such places, labourers will prefer the former class of localities to the latter. For instance, in a village agricultural commodities, which are the things mostly entering into the consumption of labourers, are very cheap; in a neighbouring town, like Allahabad, they are higher; while in a thickly populated industrial town, like Bombay and Calcutta, they are higher still. This is an important reason why wages are generally low in villages, higher in neighbouring towns and highest in the industrial centres¹².

(2) *Incidental Advantages*—Besides money wages, wage earners may enjoy various concessions and privileges. Agricultural labourers get cheap or free milk, *mattha*, and cottage. The manager of a bank gets a free bungalow. Teachers and Government servants receive provident fund or pensions. Railway servants get free travelling tickets. All such incidental advantages determine real wages.

(3) *Period and Cost of Training*—Real wages also depend upon the period and cost of the training received by the labourer. There are some unskilled occupations which require no training whatsoever; for example, the digging of earth or the lifting of bricks. Anybody can become an unskilled labourer without any training. There are other occupations which require some training involving little expenses and time. e.g., the work of motor-driving. There are

12. If nominal wages are the same at different periods, real wages are highest at that period when prices are lowest—Crew, *Economics for Commercial Students*, p. 93.

still other occupations requiring fairly lengthy period of expensive training, e.g., medical profession. These considerations must be taken into account in finding out real wages. If a motor-driver gets Rs. 30 per month and a graduate teacher Rs. 35 per month, the real wages of the latter are definitely lower than those of the former.

(4) *Trade Expenses*—In the course of carrying on one's occupation, one has sometimes to incur certain expenses. For instance, a college professor has to engage a conveyance for going to the college and to spend money on books and magazines. A lawyer, similarly, has to hire a conveyance, keep a clerk and pay to the lawyer's association. All such trade expenses must be deducted from money wages in order to find out the real wages accurately.

(5) *The Nature of Employment*—Besides trade expenses, the nature of the work is also important. Some occupations are very exhausting (e. g., blacksmithy) and reduce the working life of the labourers. Others are dangerous (e. g., lead-working) and shorten the earning period. Then there are some occupations which are definitely dirty and abhorring, e.g., the work of a sweeper or of a butcher. All such factors must be taken into account while determining real wages. As compared to such occupations, there are other lines of work which are definitely pleasant and afford much happiness, e.g., the work of a teacher or of an artist. This pleasantness increases real wages just as exhaustiveness, danger and dirtiness decrease it.

(6) *The Length of the Working Day*—Besides the nature of the occupation, the number of hours worked per day and the number of holidays also affect real wages. The difference becomes important when we compare the case of a bank manager who has to go to his bank at 9 A. M. and to come back at 6 or 7 P. M. with few holidays, with a college professor who has to take only a few periods per week and gets substantial holidays.

(7) *The Regularity of Employment*—The regularity of the employment is also an important considera-

tion. Some occupations are merely temporary, for instance, a carpenter may be employed at a particular place for a week or so but thereafter he may be dismissed and remain unemployed for a fairly long period. Similarly, sugar factories work only during winter and almost the entire staff is suspended during the off-season. The irregularity of employment reduces real wages.

(8) *Extra Earnings*—The real wages of an occupation also depend upon the possibility of supplementing the income through other sources. For instance, a bank clerk may work as an insurance agent in extra time. A lecturer may become an examiner, write books or take private tuitions. Such opportunities enhance real wages.

(9) *Employment to Dependents*—The real wages increase still further, if opportunities of employment of the various members of the family of the employed are great. In some of the industrial centres the grown up boys and wives of labourers can easily find work, while in some other places this advantage is not available.

(10) *Prospects Of Success*—Real wages are also affected by the possibility of getting a lift or of receiving higher wages in future. One may refuse a job promising high wages in the beginning but no rise later on, in preference to another job offering low wages in the initial stage but with fair chances of promotion later on.

§ 5. NOMINAL AND REAL COST OF LABOUR

Just as labourers discriminate between one occupation and another by comparing nominal and real wages, similarly employers discriminate between one labourer and another by comparing nominal and real cost of the worker. The wages paid to a labourer constitute his nominal or money cost to the employer while his productivity is his real cost. If two spinners are employed at 8 annas per day and one spins 800 yards of yarns while another spins only 400 yards,

the nominal cost of both is the same but the real cost of the first labourer is just half of that of the former.

High Wages Are Cheap Wages

The prevailing notion amongst many Indian employers is that it is economical to employ a low paid man. But the policy of depressing the labourer's standard of living through low wages stands condemned from the point of view of employers. American labour is in many industries the cheapest labour in the world because it is the best paid. High wages make possible a high standard of living. The high standard makes the labour intelligent, hopeful and full of character as well as more efficient physically¹³. The increase in efficiency is, up to a point, more than proportionate to an increase in wages. Let us take an illustration. In the above instance, if the employer gives twelve annas a day to the labourer who spins 400 yards a day and eighteen annas to him who spins 800 yards daily, then seeing the wages alone, the former is the cheaper man; but in fact, the latter is more economical. The cost of spinning per hundred yards of yarn in the case of the first labourer is $\frac{12 \times 100}{400} = 3$ annas; while in the latter case it is only $\frac{18 \times 100}{800} = 2$ annas 3 pies. Thus money cost or wages may be high but real labour cost may be low.

Low Wages Are Dear Wages

In the above example, the cost of labour is higher in the case of the worker who receives low wages. Low wages are, therefore, dear wages. Employers have now begun to realise that low wages are not economical or profitable to them. If the wages are very low, the standard of living of the worker is unduly depressed and his productivity decreases more than proportionately. Intelligent employers now aim at paying "efficiency wages" which might be sufficient

13. Ely and Wicker, *Elementary Principles of Economics*, p. 269.

to keep the labourers efficient and their productivity high¹⁴.

Long Hours Are Unprofitable

Some employers have the wrong notion that if they can make labourers work for long periods, they will be able to extract from them more work and their cost of production will go down. In fact, unduly long periods of work use up the vitality of the labourer so rapidly that his efficiency decreases more than proportionately with the result that he becomes costly. It has been found by experiment that if the number of hours are reduced up to a certain point, labourers produce more during the short time that they work than what they formerly did in the long period. Of course, if the working hours are reduced beyond that point, productivity will certainly go down.

§ 6. METHODS OF WAGE PAYMENT

The method of the payment of wages is as important as the amount paid. If the method of wage payment is very oppressive, even high nominal wages may not be very advantageous to labourers. There are two important methods of paying wages. The most frequent and important is the payment of *time wages*, i.e., wages paid according to a unit of time—daily, weekly, monthly or annually. This method is not found most suitable in all cases and wages are sometimes paid according to the unit, or piece of work completed by him. The wages paid according to the latter method are known as *piece wages*. We shall discuss below the advantages and disadvantages of each of them.

14. Cheap labour is very likely to be inefficient, while a good man, as the saying goes, is always worth his wages. The real value of labour to the employer depends entirely on its efficiency. If by giving his men shorter hours, better wages, or better conditions of labour in any way, an employer finds that their efficiency is increased, then he may find it to his interest to do so. The increased product due to the greater efficiency of their labour may more than recompense the employer for the extra wages paid. This argument is the real justification of the efforts of trade unions to improve the position of the working man—Todd, *Political Economy for Egyptian Students*, p. 64.

Advantages and Disadvantages of Time Wages

The great merits of time wages can be appreciated by the fact that this system is most extensively used. The system of time wages ensures *regularity of employment*. If the labourer falls ill for a few days, or if the factory stops working due to the breakdown of machinery or shortage of raw materials, no deduction is made from the salary of a labourer paid on, say, monthly basis. Again, it *preserves the physique of workers* by giving them no urge for over-straining themselves and thus ruining their health. Where *delicacy and perfection of workmanship* are paramount considerations, this is the best method of wage payment since it gives no stimulus to hurried or "scamped" work. Moreover, where the amount of *work cannot be measured*, e.g., the work of a supervisor or manager, this system is best of all.

The system of time wages has many shortcomings as well. Its one great defect is that it does not give any incentive to labourers for working more efficiently. On the other hand, they are sure of a definite remuneration and as such become slack. For this reason, proper supervision has to be kept over them, which increases the overhead charges. Again, this system makes the discrimination between an efficient and an inefficient worker difficult. Efficient workers are paid less in proportion to their efficiency, as compared to inefficient workers.

Advantages and Disadvantages of Piece Wages

This system is fair and just. The wage earner receives remuneration for the actual work he does. The employer also gets full return for the wages he gives. Secondly, the greater is the quantity of work done by a labourer, the more are his earnings. Under this system, then, there is an urge to increase production; each worker gets more than what he hoped otherwise to; and efficiency is automatically rewarded and inefficiency punished. The cost of supervision is also reduced to the minimum.

This system, however, suffers from serious demerits. Since wages are proportionate to the actual work done, labourers usually work very hurriedly and over-strain themselves. Their work is, as a consequence, poor in quality; besides, their health is seriously injured and they become old at a premature age. Moreover, if the labourer falls ill he does not get remuneration for the period of his absence from the factory, which is a matter of special hardship to him, living as he does from hand to mouth. Further, it creates jealousy and competition among workers.

Scope of these Methods

Too much emphasis should not be laid on the real differences between these two methods of wage payment. At bottom, both the methods have intimate relationship with each other. Piece wages are always fixed on the basis of the time required for the performance of the particular work in question. Similarly, time wages are fixed after a careful consideration of the work which can be done during a certain time. "Presumably employer endeavours to get the same amount of labour for his money whichever method he adopts"¹⁵. The primary considerations leading to the preference of one system over another are (1) the quality of the workmanship and (2) the measurability of the work performed. If high workmanship is necessary or the measurement of the work done is difficult, time wages are given; in the opposite case; piece wages are paid. Generally speaking, time wages are most widely adopted.¹⁶

§ 7. TRADE UNIONS

Meaning of Trade Unions

We have seen that the bargaining capacity of an individual labourer is very weak. They can successfully compete with employers only if they combine together and bargain collectively. With this object in view labourers organize themselves into labour or trade unions. Sydney and Beatrice Webb, authorities on trade unionism, define a trade union as "a conti-

15 Clay, *Economics for the General Reader*, p. 297

16. A very interesting account of these methods is to be found in the U. S. A. *Final Report of the Industrial Commission* (1902), pp. 735-736.

nuous association of wage-earners for the purpose of maintaining or improving the conditions of their employment¹⁷.

The functions of a trade union are the following : (1) To emphasize the common interest of the labourers and, by spreading the feeling of brotherhood, to foster unity and solidarity among them. (2) To maintain and conserve the advantages and privileges secured for the labourers. (3) To make efforts for improving their position still further, to fight the cause of the worker and to occupy all vantage positions for them. Due to this fact, it is called a *militant organization*. The chief advantages ^{for} which it fights are an increase in wages and a reduction in the hours of work. (4) To work as a benefit organization and to provide relief to the members at the time of sickness or accident and to support them when they are unemployed. This function gives it the designation of a *ministrant association*. (5) To increase the efficiency of labourers through public health campaigns, literacy propaganda and otherwise.

Trade Unions in India

Trade unions of the western variety were born in India for the first time during the 1880's. But the real beginning of the movement was made in 1918. During that year prices rose considerably while wages lagged behind; and political unrest joined hands with labour discontent. Mr. B. P. Wadia in Madras and Lala Lajpat Rai in the Punjab started some trade unions. The movement slowly spread from Madras to Bombay which now is its real home. Labourers received much sympathy from the public and public bodies like the Indian National Congress, the Home Rule League and the Muslim League. In 1923, however, conditions of labourers improved. In the early stage of the trade union movement, it is the tie of common financial distress that holds labourers together and as this tie became loose, the movement lost its vigour and vitality.

17. The Trade Union is an organization designed to put up the seller of labour on an equality with the buyer as regards bargaining strength—Clay, *op. cit.*, p. 306.

These early trade unions were merely strike committees, set up temporarily for the immediate purpose in hand and dissolved as soon as the object was achieved or could not possibly be achieved. But the Trade Unions Act of 1926, which is a landmark in the history of Indian trade unionism, changed all this. Prior to this Act, there was no special trade union legislation. The old conspiracy principles of the common law were applied to labour combinations with fatal rigour. The 1926 Act conferred many privileges upon registered trade unions. It was provided that any act in furtherance of trade disputes on the part of trade unions or anybody else was not legally punishable. It placed the movement on a firm footing in India.

It has been a source of considerable strength and stimulus to the labour movement and is its best asset. Apart from it, the All-India Trade Union Congress, which is functioning since 1920, has been the centre of unity in policy and action. In 1929, a serious split took place in the Congress camp and it was divided into the communist group, the liberal group and others. In 1935 some differences were levelled up and there arose two groups, namely, the All India Trade Unions Congress and the National Trade Unions Federation. In 1938, the differences were completely patched up and the former unity was restored. The existence of the International Labour Office has also been a very potent factor in strengthening this movement which has now been definitely linked to the world labour movement through this institution.

At present there are about 200 trade unions registered under the Trade Union's Act of 1926 and have a membership of about two lacs of workers. Women workers have so far kept aloof from the movement, only two per cent of the membership being constituted by them. Trade unionism has achieved much success amongst railway and postal employees. It is comparatively weak in the case of textile and mine workers. The unions are firmly federated together by the All-India Trade Unions Congress.

Difficulties of Trade Unionism in India

Trade unionism has not, however, made any substantial headway in this country and its rate of progress is very slow. The following are some of the difficulties of the movement hindering its rapid growth :—

(1) *The Migratory Character of Indian Labour*—Industrial labourers in India do not depend upon factory work only. On the other hand, they come to work in them only during the off season and go back to their fields when agricultural operations begin. Because of their temporary stay in factories, they fail to take an abiding interest in trade unions which cannot, therefore, be easily organised on a permanent basis.

(2) *Heterogenous Character of Indian Labour*—The labour force of our industrial centres is constituted by labourers drawn from different provinces, different castes and different religions. They speak different languages and have different customs and modes of living. Consequently, they cannot mix freely with each other and the bond of unity is often weak.

(3) *Lack of Discipline*—Indian Labourers are not used to party discipline. They often find the rules and regulations of trade unions irksome and the subjection to them, an uncalled for bondage.

(4) *Poverty of Indian Labourers*—Our labourers are very poor and cannot easily pay the membership fee of trade unions. Consequently, many of them do not join the unions and even if they do join them, they commit defaults in regular payment when their names are struck off the register.

(5) *Illiteracy*—Labourers, being illiterate, fail to appreciate the real purport of trade unionism. They do not understand that by combining themselves, they can offer collective resistance against the employers and secure advantages which they would never be able to obtain individually.

(6) *Lack Of Labour Leaders*—Labourers do not have their own leaders. Usually politicians assume

the role of labour leaders when it is politically advisable to stir labour discontent, and withdraw as soon as the political necessity loses force or the political movement languishes. However, some sustained and regular work is done by them and also by lawyers who also become labour leaders. As leaders they are not as useful as labourers themselves in that capacity.

(7) *Opposition Of Employers and Supervisors*—Employers oppose trade unionism in various ways and because of their strong bargaining capacity, they often become successful. Again, the supervisors and bosses who supervise and employ labourers can exercise their authority easily when labour is disorganized. Hence they offer resistance to labour combinations.

In course of time, however, as these hindrances weaken, trade unionism will gather force in our country. Meanwhile attempts must be made to put the movement on a strong footing and to direct it into the right channel from the very beginning.

§ 8. WAGES IN INDIA

Wages in India are very low and the standard of living of labourers and their efficiency are poor as a consequence. The rate of wages in rural tracts is lower than that in towns and cities. This is partly ascribable to the fact that the purchasing power of money in villages is higher than what it is in cities and towns. But the difference is wider than what such considerations suggest. The reason is that in rural areas, wages are fixed not so much by competition as by custom. In so far as competition has any influence on wages, it is towards their decrease, for the supply of labour, more often than not, is greater than the demand for it. In cities, on the other hand, competition plays an important role in the wage determination and the scarcity of labour favours the workers. Gradually, as competition is coming into prominence, the difference in nominal wages in rural and urban areas is coming nearer to the difference in real wages.

The general rate of wages has a tendency to increase for a variety of reasons. Practical experiments conducted in India and elsewhere have shown that low wages are dear wages. It is profitable to pay high wages since the increased payment brings more than proportionate reward in the shape of increased productivity of labourers. Labourers themselves have begun to realise, though at present nominally, that if they become more efficient, their wages will increase. Moreover, the trade union movement is gathering strength slowly but steadily and has succeeded in many cases in securing a rise in wages. The work of International Labour Office has also done much to improve the lot of Indian labourers.

of its productivity to its owner, as a reward of his abstinence².

The Problem of Interest

The problem of interest is divisible into three broad questions:—

(1) Should interest be paid on moral and ethical grounds?

(2) Why is interest paid and charged? This differs from the first question inasmuch as this is a purely economic issue while the preceding one is mainly moral and ethical.

(3) How is the rate of interest determined?

Of all these questions, the last one is the most important and will be discussed in § 2. The first two questions are dealt with below.

1. Should Interest be Paid?

The question of the ethical justification or impropriety of charging interest is mainly a moral one; and economists are not directly interested in it. But, like all the ethical problems, it has an economic aspect and is, therefore, discussed below.

✓ 2. Interest is the income which capital returns to its owner whether he lends it or employs it himself in his own business. There are three forms in which this income may be returned. In the first place, it may come as payment for the loan of a general fund of wealth. Such a loan usually takes the form of money or some substitute for money, such as a credit instrument. In the second place, the capitalists income may be received for the loan of certain specific pieces of capital such as building and machinery, and in the third place, it may be secured from the use of capital in his own business.

In popular language, only the first form of the capitalists' income is invariably called interest. The second is called either rent or interest, and the third either profits or interest. But since they are all alike in being derived from the ownership of capital, economists have generally chosen to call them all by one name, and have chosen interest as that name, reserving the word "rent" for the income derived from the ownership of land, and "profits" for an income which has been variously described, but which usually has some connection with the peculiar function of the independent business man himself rather than with that of his land or capital.—Carver, *Distribution of wealth*, pp. 213-214

The Condemnation of Interest in Ancient Times—

In ancient and mediaeval times interest was generally condemned. The church forbade the lending of money on interest. Plato looked down upon usury and Aristotle criticised it in unmistakable terms giving the progeny the celebrated phrase "Money is barren, it cannot breed money". The Islamic religion also prohibited it strictly. The reasons for this universal deprecation of interest was that in those days the society had not much developed industrially and commercially. Money was generally borrowed in times of want, distress and prodigality. As such, (1) lenders could easily oppress the borrowers by charging exorbitant rates which often ruined the borrowers; and (2) since capital was not put to productive purposes, the fallacy that capital could not "breed money" and the charging of interest was therefore unjust, could arise even in a mighty mind like that of Aristotle. Due to these reasons interest was condemned. This prohibition was also partly due to the fact that most of the moneylenders in Europe were Jews, who were non-Christians and were an eye-sore to Christians.

It is significant to note that the code of Manu in India did not forbid interest. It shows that Manu and other ancient thinkers of this country were intellectually supreme and considered the problems in all their aspects. It was also due to the fact that India was industrially and commercially an advanced nation in those times and the productivity of capital was well appreciated³.

*The Modern Justification—*Slowly the world emerged from the industrial and commercial backwardness. Inventions in various spheres gave an entirely new outlook to the people. Manufacturing machinery multiplied. The network of the means of transport and communication began to spread rapidly. Trade, national and international, increased by leaps and bounds. The productive nature of capital asserted

3. For a very lucid account of the early history of interest, see Irving Fisher, *The Rate of Interest*, pp. 47. Also Dr. A. S. Gour, *The History and the Law of Interest*,

itself with unmistakable prominence. It began to be realised that since capital brings financial benefits to the borrower, it is only fair that he should give a part of that benefit to its owner. It was also felt that saving involves the postponement of present consumption on the part of the capitalists, a sort of pain which will not be deliberately borne unless rewarded. These considerations made the old prohibition against taking interest, obscure and today it has become a thing of the past. This change vividly brings before our mind how does Economics influence Ethics.

Interest And Usury—Though interest is generally justified (except by socialists), usury is usually looked down upon. Usury differs from interest in the sense that it exceeds the latter and is, therefore, unjust.⁷ It may be described as exorbitant or excessive interest⁴. It may well be likened to rack-renting. Under special circumstances, a landlord can charge rent higher than economic rent; such an action is called rack-renting. Under similar circumstances, a capitalist can charge more than the proper rate of interest; such excessive interest is called usury. Usury is deprecated ethically, condemned socially and often prohibited legally⁵.

II. Why is Interest Paid and Charged ?

We shall now discuss the economic conditions which make the borrower pay and the lender charge interest.

The borrower pays interest because he knows that capital is productive and out of its productivity he can pay a sum in the shape of interest to the capitalist. For instance, an ordinary cap-maker in a village, working without a sewing machine may be earning Rs. 10 a month. He knows that if he has

4. The term 'usury', as contra distinguished from interest proper, signifies interest at a rate higher than that limited by law as legally exigible—Dr. A. S. Gour, *The History and Law of Interest*, p. 135.

5. The exact rate of interest.....is determined by supply and demandbut clearly the lender must not extort a rate of interest greater than that which it is fair and reasonable to demand. In certain cases the law of the land steps in to control the rates at which money may be lent—Crump, *A first Book of Economics*, p. 99.

a sewing machine, he can make more caps and earn, say, Rs. 20 per month. The productivity of the machine, then, is Rs. 10 per month. Now, if he is offered sufficient money to purchase a sewing machine on the payment of of Rs. 5 per month as interest, he will readily agree to the transaction. He will have to pay only a part of the productivity of machine as interest, the remainder being left with him. The second consideration which forces him to pay interest is the fact that the capitalist saves capital painfully. He postpones the satisfaction of many present wants and by stinting the present pleasure, saves capital. Not only this; he himself does not use capital productivity, but foregoes that privilege in favour of the borrower. For this abstinence or sacrifice, he must be rewarded. Unless this reward is forthcoming, he will not supply capital. That is why the borrower consents to pay interest. The productivity of capital enables the borrower, and the abstinence or sacrifice involved in its supply compels him, to pay interest⁶.

These considerations also work in the minds of the capitalist and make him charge interest. Firstly he knows that capital is productive; hence if he does not derive the benefit of its productivity himself and gives this privilege to somebody else, he must get a fraction of that benefit. Secondly, he wants some reward for the abstinence or sacrifice he has to put up in supplying capital.

6. If we appeal to the common consciousness to say what it is that capital does, or forbears to do that it should receive interest, we shall probably get two answers. One will be that the owner of capital contributes a valuable element to production the other, that he abstains from using his wealth in his own immediate consumption. On one or other of these grounds, the capitalist is said to deserve a remuneration, and this remuneration is obtained by him in the shape of interest. The first contribution is positive—that capital does something the other negative—that the capitalist abstains from doing something. In the one case interest is a payment for a tool, in the other, a recompense for a sacrifice. The first answer is the basis of the Productivity theories and of the Use theories; the second is the basis of the Abstinence theory—See Smart's Preface to the Translation of Bohm Bawerk, *Capital and Interest*, pp. VII-XVII.

The reasons, then, why, interest is paid and charged are the productivity of capital and the abstinence or sacrifice involved in its supply.

§ 2. THEORY OF INTEREST

We shall now discuss how the rate of interest is determined. This question has occupied the attention of economists from very early times and various theories of interest have been propounded. The most important of these theories are (i) The Productivity Theory, (ii) The Abstinence Theory and (iii) The Austrian Theory. These theories contain some truth but do not discuss the problem in its entirety and with perfect accuracy. Often they throw light only on one aspect of the problem. They have, therefore, been substituted by the Modern or the Demand and Supply. Theory of Interest, which is considered to be the best available explanation of the way in which interest is determined. According to it, interest is determined by the demand for and the supply of capital. It is the point of equilibrium at which the demand for capital is equal to its supply.

I. Demand For Capital

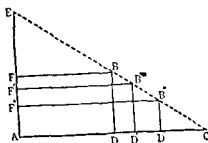
Demand for capital comes from those, who want to use it productively, e.g., traders, manufacturers, and agriculturists. Sometimes Government also borrow money for the construction of productive works like hydro-electric projects, means of transport and communication, etc.

A producer demands capital because it is productive; and, other things remaining the same, the productivity of each successive unit (or marginal productivity of capital) goes on diminishing till a point is reached at which the productivity of the last unit of capital is equal to the interest he is required to pay for it. The employer will stop at this point and will not demand capital any more. The last unit of capital is called *final unit* because it is the last unit which a capitalist can, or will, employ. It is also called *marginal unit* because it is on the margin of employment or rejection; the employer may use this unit or may not use it. The productivity of this marginal

or final unit of capital is known as *final or marginal productivity of capital*⁷.

The maximum that the borrower will pay for the marginal unit of capital is its productivity he will not pay more than that. And since each unit of capital is interchangeable with any of the other units, he will pay the same for the latter as well. It follows, therefore, that the *marginal productivity* determines the maximum that the producer is willing to pay for the use of capital.⁸

7. The working of the law of marginal productivity as applied to capital might be illustrated by means of the following diagram —



Let the amount of capital be measured along the horizontal line AC, and let the productivity of capital be measured along the perpendicular line AE, and let the descending line EC represent the rate of decrease in the marginal productivity of capital. If the amount of capital were measured by AD, the *marginal productivity* would be measured by the line BD or AF. If the amount of capital were measured by AD', the marginal productivity would, other things remaining equal, be measured by the line B'D' or A'F'; and when the amount of capital equals AD'', marginal productivity would be equal to B''D'' or A''F''. If capital went on increasing to AC, the marginal productivity of capital will be destroyed altogether—Carver, *op cit*, pp 223

8 Money demanded for non productive purposes cannot, according to our definition of capital, be included under this term. But non-productive demand is similar to the demand for productive purposes and, therefore, exercises an influence on the determination of interest on capital. It is, I believe, for this reason that some economists add the non productive demand to the productive demand in order to arrive at the total demand. It should be remembered, however, that in the case of capital used productively, it is the *marginal productivity* which determines the maximum limit of the rate of interest. But in the case of wealth borrowed for non productive purposes, it is the *marginal utility* which determines this maximum. This difference does not appear to me very important in this context, and the above method of treatment may be followed.

2. Supply of Capital

The supply of capital involves abstinence or sacrifice and unless a reward for it is forthcoming, capitalists will not supply capital. The money measure of the abstinence or sacrifice involved in supplying capital is, then, the minimum below which interest cannot fall. It may be called the cost of production of capital; and just as the cost of production of a commodity determines the minimum limit of its price, similarly the cost of production of capital determines the lowest limit to which the rate of interest can fall.

Determination of the Rate of Interest

Between these two limits, the maximum as determined by the marginal productivity of capital and the minimum as fixed by the abstinence or sacrifice involved in the supply of capital, the rate of interest is determined according to the relative forces of demand and supply by mutual bargaining and higgling of borrowers and lenders. In new countries where men happen to be progressing economically, the demand for capital is great; so the rate of interest is high. As communities grow and advance, capital increases and is more than enough to meet even increased demand; so the rate of interest falls⁹.

§ 3 NET AND GROSS INTEREST

Meaning

The payment made exclusively for the use of capital, is called *net interest*. It may be variously defined as the income derived from capital invested in channels free from risk, inconvenience and management duties. What the borrower actually pays to the capitalist for the use of his capital is known as *gross interest*¹⁰. The payment so made includes, besides net interest, any or all of the following factors :—

9. Cornah, *Simple Economics*, pp 24 25

10. Gross Interest is what we mean by interest in ordinary talk, the whole amount that a borrower has to pay, while net interest is that portion of the gross interest which is paid simply for the use of capital—Moreland, *Introduction to Economics*, p. 252.

(1) *Insurance Against Risk*—When a man entrusts his capital to somebody else for some time, he incurs the risk of its loss as a result of the inability or unwillingness of the borrower to pay back his debt. To cover this risk he makes some charge which is added to the net interest.

The risk is of two kinds : (a) *Business Risk*. The business followed by the borrower may be safe or risky. For instance, the work of a publisher is not so risky as that of a speculator. As such the charge made for the risk by the lender of capital will be greater in the latter case than in the former. The risk attached to the business of the borrower determines his ability to pay. (b) *Personal Risk*. A man may be able to pay but may not be willing to do so. He may be of dishonest intentions. The gross rate of interest charged from such man will be naturally high. It will be low in case of the borrower who is famous for his integrity and who takes pride in paying off the debt as readily as possible.

(2) *Remuneration for Inconveniences*—Some investments of capital involve many inconveniences. In some cases money is payable at any moment, maybe at the time when the borrower has no other source of investment; in others, it may be payable only after a very long period. Again, investment may be made only in large amounts. For example, in the shares of Reserve Bank, the value of each of which is one hundred rupees; or, it may be made in small amounts, like the deposits in savings bank account. The capitalist charges something for such inconveniences. An ideal investment is one where money may be invested at any time and in any amount and withdrawn whenever desired. Such an investment involves no inconvenience and no remuneration is charged for it.

(3) *Remuneration for Management*—The lender has to spend money and energy in the management of investment. He has to discover the likely borrowers and carefully consider the safety of the loan made to them. He has to settle the rate of interest

with them. The necessary legal formalities have to be undergone. Proper accounts have to be maintained. The borrowers do not pay punctually and reminders have to be sent constantly till the debt is cleared off. For this management, a charge is made in the shape of an addition to the net interest. In our rural areas the small debts made by *mahajans*, *pathans* and *kabulies* involve much labour and management. Repayment is arranged in small instalments and for the collection of each instalment, villagers have to be approached several times. This is one reason why the rate of interest is so high there.

Variations in Gross Interest

Generally speaking, the net rate of interest is more or less the same everywhere: competition among borrowers and lenders tends to reduce it to the same level. But due to variations in the risk involved in the loan, inconvenience of investment and the labour of management, gross interest (which is called interest in everyday speech, though not in Economics) differs widely. Investment in Government securities is quite safe, is not inconvenient and does not involve any labour of management. It is, in fact, the nearest approach to the net interest in practical life. The rate of interest payable by strong and well-known banks is also sufficiently low. The interest which a city business man or manufacturer pays is more than that paid by the Government in proportion to the risk, inconveniences and managerial duties involved. When we come to rural areas, we find even higher rates of interest. This is partly due to the fact that the loan given to the agriculturist is very risky. In spite of his sincerity, he might not be in a position to repay the loan. It is the experience of money-lenders that once the loan is given to the cultivators it is repaid very gradually. Moreover, the inconveniences of such a loan are also great, there being no definiteness about the duration, amount, or repayment of the loan. Finally, the labour of management, as seen above, is also tremendous.

Rates of interest also vary from country to country. This is due to the international immobility of capital. Investors in foreign countries have the fear that if the foreign debtor does not pay, the trouble and expenses of taking legal action against him will be huge. Moreover, foreign courts may not be just to him always and in all cases. Finally, if international hostilities break out, foreign capital may be forfeited entirely—even the Government loans are repudiated in such case. These causes, together with those discussed above, make for variations in the gross rate of interest from country to country.

§ 4. THE RELATION OF INTEREST TO PROGRESS AND RENT

Effects of Progress on the Rate of Interest

As society progresses socially and economically, demand for capital goes on increasing. Firstly, the use of machinery extends. Mechanisation and re-mechanization progress cumulatively. Scale of production and of trade becomes large. Huge capital is, therefore, demanded. Secondly, the modern State tends to embark upon increasingly ambitious schemes in the interest of its members, which are sometimes financed by loans. Finally, much capital is destroyed by wars, natural calamities etc. and demand for fresh capital to take its place often arises. Though all these causes increase the demand for capital, its supply increases much more rapidly. Substantial improvements in methods of production and in the efficiency of industrial organization increase the amount of wealth produced per year. Savings become larger as people become more prudent to realise the value of keeping something for the future use. The supply of capital thus out-strips the demand for it with the progress of society with the result that the rate of interest tends to fall. This has been amply proved by the history of interest during the recent past¹¹.

11. See A. N. Agarwala, *Insurance Finance*, p. 43n. An interesting objective evidence of a fall in the rate of interest is the rate assumed by insurance companies in their calculation. This has been continually

Zero Rate of Interest—Some economists believe that the tendency of the rate of interest to fall will go on increasing till a stage will be reached when it will become zero. It is difficult to agree with this point of view. This theory substantially means that after some time a stage will come when our wants will be satisfied and we need not employ any capital for the production of wealth. The marginal productivity of capitals, in other words, will drop down to zero. But human wants, as we know, are innumerable; and as soon as one want is satisfied, another arises. So long as this continues to be a fact, there will remain numerous channels for the profitable employment of capital. Again, zero rate of interest can exist when people are willing to save without any expectation of reward; in other words, when they become so perfectly rational as to realise the value of providing something for the future use and to feel no pain in saving. The assumption of perfect rationality of human beings is a mistake because men are seldom perfect. It is, therefore, wrong to suppose that a stage will arrive when the rate of interest will drop down to zero¹².

Rent and Interest

Interest is the share of national dividend accruing to capitalists while rent is the share available to landlords. In short period, both rent and interest are similar. Capital cannot be increased in short period; neither can be land. This is the reason why income on capital goods, which are limited in supply in the short period, is called *quasi-rent*. It is, however, in the long period that the real difference appears. The supply of capital can be increased in long period; the

declining. Thus Gustav W. Smith assumed 4% interest in 1875 in his *Notes on Life Insurance*, Riegel and Loman, 3½% in their *Insurance Principles and Practices* (1924), while recent works take 3% interest in their calculations, e.g., see Maclean, *Life Insurance*.

12. Proudhon argued that since the rate of interest declines as civilization advances, its total abolition was only a question of time. This is as good a proposition says Bastiat, as this—since the most skilful agriculturists are those who have reduced the heads of sheep to the smallest size, we shall arrive at the highest agricultural perfection when sheep shall have no longer any heads!

supply of land, on the other hand, is fixed for ever. As such, while the progress of society, which increases the demand for capital and land alike, depresses interest, it stimulates rent. Moreover, net rate of interest is equal everywhere, but rent differs from place to place according to differences in fertility or accessibility, or both. Finally, rent of a land is the excess of its production over that of the marginal or no-rent land, but interest is not determined in this way; in fact, there is no capital on which no interest is paid.

§ 5. INTEREST IN INDIA

Rate of interest in India has three main features - (1) It is very high. (2) It varies from one place to another. (3) It changes from season to season. We shall study these characteristics in detail.

High Rates of Interest in India

In our country, the rates of interest are very high as compared to other countries of the world. High rates of interest constitute an effective obstacle to the industrial and economic development of the country. The causes of high rates are the following:—

(1) *Huge Demand for Capital*—India is economically little developed but is gradually emerging from the state of backwardness. The demand for capital is, therefore, huge. Enormous capital is required by industrialists for starting industries like iron and steel, cement, match, paper, silk etc. Agriculture also requires capital for permanent improvements, better equipment, and machanisation. The Government also float loans for extending hydro-electric works, railways and other means of transport and irrigation. The demand for capital being so great, other things remaining the same, the rate of interest is likely to be high.

(2) *Scarcity of Capital*—While discussing the accumulation and supply of capital in our country, we found that the ability and willingness of our people to save is very weak. Naturally, the supply

of capital is little as compared to the demand for it. The amount of wealth not spent by the masses of country is hoarded rather than deposited in some bank or used productively and thus converted into capital.

(3) *Defective Banking Organization*—The banking system of the country, which is the connecting link between borrowers and lenders, is very disorganised and defective. Banks being very few in number, difficulties in depositing money and in taking loans are great. Again, the lack of various types of banks leave many credit requirements unattended. These conditions push up the rates of interest.

(4) *Usury*—The village mahajan, under the circumstances, charges usurious rates of interest. He occupies a monopolistic position and has to give loans on little, or no, security to persons who might not be able to pay in spite of their best intentions.

(5) *Loans for Consumption Purposes*—Borrowers use the money borrowed by them for productive and unproductive purposes indiscriminately. Productive loans are safe because they produce wealth out of which the loan can be paid back. This is not the case with non-productive loans. Hence the utilisation of loans for non-productive purposes increases rates of interest.

Local Variations in Interest

Another important feature of interest in India is that the rates of interest differ considerably from one place to another. (1) The difference between the rates prevalent in urban and rural areas is specially noteworthy. This is because of the fact that India possesses two money markets, urban and rural, rather than one. The urban money market is well organized and here the rates of interest are fairly low and uniform. The rural money market, on the other hand, is disorganised and here the rates of interest are high and varying.

Seasonal Variations in the Rates of Interest

India is an agricultural country; and, as is inevitable in an agricultural economy, the demand for money increases in particular seasons when crops are harvested and moved but becomes slack as these operations come to an end. In India *rabi* and *kharif* are the two crops. And the months of April and May and of October and November are the months when the demand for money is very brisk. This period happens to coincide with the period during which marriages generally take place. This increases the demand for money still further. During this period, therefore, the rate of interest climb up. But, in other months, the demand is less and the rates of interest fall. This defect can be removed if the Reserve Bank of India pumps money into circulation in the busy season and withdraws the same in the slack season. But it has hitherto failed to fulfill this function efficiently and seasonal variations still continue,

CHAPTER VII

PROFITS

The true rate of profits in large businesses is higher than at first sight appears because much that is commonly counted as profits in the small business ought to be classed under another head before the rate of profits in it is compared with that in a large business—*Marshall*

§ 1 INTRODUCTORY

Meaning of Profits

The share of the national dividend accruing to the entrepreneurs is known as profit. Economists are not yet agreed as to the constituents of profit and the way in which it is determined. Considerable difference in opinion exists and makes the subject a confusing one to the beginners. We shall, therefore, discuss what appears to us to be the most reasonable opinion on the subject.

Profit a Residuum

Before proceeding further, let us see how profits are found out in practical life. The entrepreneur anticipates the probable future demand and the price of the goods he contemplates to produce. On the basis of this estimate, he enters into separate contracts with landlords, capitalists, labourers and organizers; and production is commenced. The entrepreneur makes payments to the various agents of production according to the rates agreed upon. If something is left from his income after payments are made to the agents concerned, it is his profit. If, on the other hand, if his income falls short of the payments he makes, he incurs a loss. Profit is only a residual share of the produce of industry.

It should be remembered that profit is a residual share, not in the sense that rent, interest, wages and salaries are determined by certain special laws applicable to each of them; while any residue left out after these payments have been made is called profit, there

being no other law governing its determination. In fact, profit is also determined by its own law. Profit is a *residuum* in the *practical sense* that what is left over after the payment to all the agents of production is known as profit¹.

§ 2. GROSS AND NET PROFITS

Meaning

In the popular sense, the word profit is used to denote the total return to the entrepreneur after paying rent and interest for the land and capital hired and wages and salaries for the labour and organization employed. In other words, it is equal to the excess of the receipts of a business over the actual expenses incurred by the entrepreneur. This profit is known as *gross profit*.

Net profit is not so extensive a term as gross profit. A reward accruing to the entrepreneur for this risk-taking function and his bargaining skill is known as *net profit*.

Constituents of Gross Profit

Gross profit is made up of various constituents of which net profit is one. It is, therefore, instructive and interesting to find out its other constituents. The various elements which may be included in gross profit are given below:—

(1) *Rewards to Other Factors of Production Supplied by the Entrepreneur Himself*—In many businesses, entrepreneur himself supplies various factors of production. He is not required to make any payment in respect of them to any outsider; nor does he, generally speaking, himself receive any reward separately. Thus payment is usually merged in the gross profit. In estimating net profit, therefore, we should deduct from gross profits the rewards to the factors of production, other than the enterprize, supplied by the entrepreneur himself. These rewards may be the following. (i) *Rent on Land*. The entrepreneur might have supplied land, the

1. See Carver, *Distribution of Wealth*.

reward for which must be deducted from the gross profit. (ii) *Interest on Capital*. Generally speaking, the entrepreneur supplies some capital. Unless he risks his own capital in the venture, he may not get much capital from others. (iii) *Wages for Labour*. Sometimes an entrepreneur himself works as a labourer as is the case with our cultivators. He then becomes entitled to certain wages. (iv) *Salaries for Organization*. Whenever an entrepreneur performs certain managerial duties, a reward accrues to him, which should be deducted from the gross profit in order to arrive at the net profit.

(2) *Charges of Maintenance*—(i) *Depreciation Fund*. In the second place, some provision has to be made for the maintenance of the capital, or its replacement, as it is gradually used up or becomes obsolete due to better inventions. This provision is known as *depreciation*. Depreciation charges must be deducted from gross profit in order to arrive at net profit, as depreciation charges are the expenses of business. (ii) *Insurance Charges*. Sometimes a careful business man sets aside a certain sum of money as a provision against possible loss. Something has to be deducted from the gross profit in the shape of insurance charges *before we can arrive at the net profit*.

(3) *Extra-Personal Gains*—Even after making all these deductions our analysis is not complete. We have also to deduct the extra-personal gains, i.e., gains which are not due to the efficiency, or ability, of the entrepreneurs : (a) *Monopoly Gains*. For instance, a business may possess certain monopoly advantages. He may have an effective control over the supply of the article he deals in. In this case his profit will increase (but his own efficiency is not responsible for this increment.) Therefore, it has to be subtracted from the gross profit. (b) *Conjunctural or Chance Gains*. Again the occurrence of certain unforeseen circumstances may enable a business to additional reward. For instance, when a great personage dies there is an unusual demand for mourning goods and traders in the line make great profits. Again, if war breaks out dealers

in arms and ammunitions make huge profits. Such gains are extra-personal resulting as they do ✓ from a favourable conjuncture of circumstances which could not have been foreseen. They cannot strictly be regarded as pure profits and have to be deducted from gross profits.

(4) *Pure or net Profit*—When all the above deductions have been made from the gross profit the remaining sum is the net or pure profit. It is the reward for two main functions:—(i) *Risk-taking Function*. An entrepreneur takes risk on his estimate of future price and the extent of the demand. He agrees to pay certain remuneration to the various agents of production. If he gets a price higher than what he estimates, he makes large profits. If the price realised falls short of his expectations, he incurs a loss. "That it is the owners of business who take the chief risks is clear when we remember that they have paid for the labour, capital and land before the commodity is finished, often before its price can be found and if the commodity when made is not wanted and cannot be sold, they cannot recover wages, interest and rent expended in the production of it². (ii) *Bargaining Skill*—While employing various agents of production, the entrepreneur tries to strike as profitable a bargain as possible. The degree of his success depends upon his bargaining skill. The reward for risk-taking and the bargaining skill takes the shape of net profit³.

The constituents of gross profit are shown in the diagram below :—

2. Henry Clay, *Economics for the General Reader*, p. 337.

3. The business man is essentially an enterpriser, an *entrepreneur*, as he is sometimes technically called. Both terms signify one who undertakes or assumes risks. It is the reward of this special function which, together with ✓ the results of superior bargaining constitutes the peculiar income of the business man, such an income as is never earned by any one except a business man who undertakes risks—Carver, *Distribution of Wealth*, pp. 296-297.

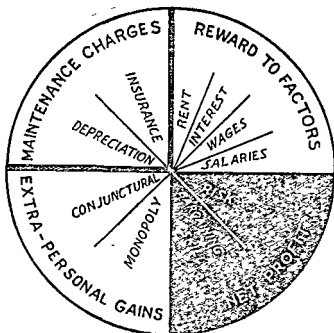
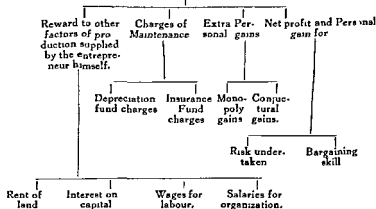


Diagram showing constituents of Gross Profits

The above idea can be tabulated as below :—

(Income = Expenses)



The Concept of Net Profit

According to the above description, net profit is the reward for the risk undertaken and the bargaining skill. This is the viewpoint of American economists. Older economists had the wrong notion that net profit also includes the reward for the capital contributed by the entrepreneur himself. In those days, the form of business organisation was primitive. One man's business and partnerships were the common rule. The risk-taker himself supplied the whole of the capital. As such, their idea that an entrepreneur must also be capitalist and that net profit includes interest was not wrong for the times they lived in. In these days capital is supplied by certain persons while risk is borne by altogether different persons. Hence this point of view is not correct for our own times. F. A. Walker, an American economist, was the first man to draw distinction between the functions of an entrepreneur and that of a capitalist. He showed that an entrepreneur need not supply any capital whatsoever, though he generally supplies a substantial part of it. This view is now accepted by everybody.)

Marshall and his English followers maintain that an entrepreneur also does the work of an organiser and his reward for organisation is included in net profit. This opinion should now be regarded out of date. An entrepreneur need not himself do the work of an organiser. In a typical joint stock company, for instance, the function of organization is usually delegated to paid managers. It is thoroughly separated from entrepreneurs. Consequently, it is necessary to keep organization and enterprise as two different factors of production⁴.

§ 3. HOW PROFIT IS DETERMINED

Economists are not agreed as to how profits are determined. Different opinions have been put forward

4. I very strongly maintain that logical sense makes the separation of organization and enterprise inevitable and essential. The Marshallian view is too conservative to be applicable to modern conditions.

by different economists. We shall give here what appears to us to be the most reasonable explanation of the determination of profit. While reading other books, students will come across different analysis of gross profit and different theories of the determination of profit. They should not be upset by the diversity of opinions. In the elementary stage, they might understand one explanation and if they are satisfied with it, they should stick to it.

Normal Rate of Profit

✓ At the outset, it should be made clear that no entrepreneur will undertake a risk unless he gets a reward for it. In the short period, of course, he may incur a loss, but he may still continue to remain in the business in the hope that he might make good profit in near future. But in the long period, he must earn reasonable profit for his risk-taking function and bargaining skill. This reasonable profit which is essential to persuade the entrepreneur to undertake the risk is known as normal profit, and *enters into the expenses of production*. This is an important point and should always be borne in mind.

Determination of Profit

Profit, as we have seen, depends upon the personal qualities of the entrepreneur. Personal abilities of the various entrepreneurs show considerable divergence. The abler the entrepreneur, the higher the profit, and *vice versa*. There are some very able entrepreneurs who earn magnificent profits. On the other extreme, there are those unfortunate employers whose income is just sufficient to enable them to meet their expenses (including normal profit) and to keep their heads above water. "At this point, where success is scarcely better than failure, profits are at a minimum; we may, in fact, regard such business man as the.....marginal class of entrepreneurs, and from this low point upward we measure profits. As the ability, foresight and courage of the entrepreneur increase, so does his reward in the form of profit becomes greater, and at any particular point the amount of profit is proportionate to the

superiority of the abilities of the more capable employer over those of the employer at the marginal⁵.

Rent of Ability—It would have occurred to the reader from the above that profit is determined just like rent. The differential advantage of the super-marginal land over the marginal land determines rent; similarly, the superior abilities of a particular entrepreneur over his marginal compeer determines profit. As such, profit is often described as the *rent of ability*⁶.

§ 4. CALCULATION OF PROFIT

Profit Per Annum

Profit is generally calculated as percentage of the capital employed during a year. Suppose, during the year 1939, a business man who has invested Rs. 1,000 as capital, makes a profit of Rs. 120. His rate of profit then, is $\frac{120 \times 100}{1000} = 12\%$.

Profit on Turnover

When the sales of the business come to the level of the capital employed in the business, there is said to be one capital turnover. It simply means that the capital is turned over once. If during a year, total sales amount to 4 times the capital employed, there have been 4 capital turnovers.

Sometimes profit is expressed as a percentage of the capital turned over during the year, then it is known as *profit on turnover*. In the above example, we assumed that 12 per cent profit is made on the capital of Rs. 1,000. Now, if the capital has been turned over four times during the year (in other words, if the total sale comes to Rs. 4,000 during the year)

5. Thomas, *Elements of Economics*, p. 331.

6. In this theory, the critic may say it has not been explained how the rate of normal profit is determined. This I suppose is simple enough. This depends upon the demand for and the supply of enterprise. If demand exceeds supply the normal rate of profit will be high and vice versa. At any particular time, the rate of profit is the equilibrium point at which the demand for and the supply of enterprise are equal to one another.

the rate of profit on turnover is 3 per cent only. Were the capital turnover twice, the rate of profit on turnover would have been 6 per cent.

✓ If a business man keeps profit on turnover to a small figure, his prices will be fairly low; his turnover will increase as a consequence and his profit in total will be fairly large. If he keeps the profit on turnover fairly high, his prices will also be high; his turnover will decrease and his profits may become small. Profit, thus, depends upon the percentage and the turnover; and usually if one is increased, the other decreases. This alternative always presents itself to the business man who resorts to the course best to his mind.

§ 5. TENDENCY OF PROFITS TO FALL

As society progresses, profits tend to fall because the rate of increase in the supply of enterprise exceeds that in the demand for it. In this respect, then, it resembles interest which behaves in the same manner due to the operation of the same causes. It is, of course, unlike rent which rises with the progress of society due to its limited supply.

As knowledge increases and becomes the possession of an ever increasing number of the members of a society; as inventions spread and an increasing number of employers are enabled to obtain access to new inventions and new processes; and as the number of men of ability of any community becomes even more plentiful with the increasing advantages for obtaining mental and technical equipment; so do the opportunities to make exceptional gain tend to become less frequent and profits as a whole tend to touch lower levels. This tendency is somewhat offset by a greater demand for enterprise in the new industries, set up for supplying new wants. But the increase in demand does not keep pace with increase in supply and the profits tend to fall.

§ 6. PROFITS IN INDIA

The level of profits in our country is low as a general rule for a variety of reasons.

Profits in Agriculture

The agriculturists of this country have been carrying on agriculture at a loss in recent times. The rent that they pay is very high. The majority of the population has to depend upon agriculture because there is no other occupation available to them. Consequently, the demand for land is so great that landlords can indulge in rack-renting without arousing an effective opposition. In the rural tracts, rates of interest are also high for reasons we have already discussed. Agriculturists have to pay only rent and interest, they themselves supplying labour, organization and enterprise. Their outgoings (i.e., rent and interest) are definite in amount either because they are fixed by long contracts or because they are customary. But the prices of agricultural commodities have shown the tendency during the recent past to sink lower with the result that the excess of the incomings over the outgoings has greatly decreased, so much so that cultivators find it difficult to meet both ends together. This is with regards to gross profit. If we try to find out the net profit and make proper allowance for the reward of labour, organization and enterprise supplied by the cultivator himself, we find that agriculture is being carried on at a loss. The present war has, however, improved their conditions a bit⁷.

Profits in Large Scale Industries

Conditions are not so bad in the field of large scale manufactures. Profits do arise in their case. But profitable industries are very few. Moreover, they suffer from low profits due to unfair foreign competition, unsympathetic State policy, high taxation, etc. Unless a vigorous industrial policy is pursued by the State and in particular a protectionist policy of a deep shade is adopted, much cannot be done.

Profits in Small Scale Industries

In the olden days, India possessed very flourish-

7. See A N Agrawala, *The Present War as an Economist sees it*, *Industry in India*, Sept. 1939, and *Industry and War*, *the Leader*, Sep. 13, 1939.

ing handicrafts, reputed throughout the world for their unique excellence. But the growth of foreign large scale factory industries wrote their death sentence. Their condition has been worsening day by day and their profits dwindling in sympathy. Recently, the Indian National Congress has been making efforts to revise them. If successful, they might be put on a profitable footing.

Profits to Traders

This survey will not be complete without a description of the profits made by traders and business men. Their conditions are, however, different and various among themselves, so that no general statement can be made. But, on the whole, they have been faring well.

CHAPTER VIII

SCOPE FOR ENTERPRISE IN INDIA

For the sake of prestige and out of fear of what might happen during war time, most governments now desire whatever the cost and however great the natural handicaps to produce within their own territory as many as possible of the commodities produced more easily elsewhereThe progress of technology has made it possible for governments to fulfil such wishes, at any rate to a considerable extent, in practice—*Aldous Huxley*.

In India, enterprise has been very scarce in recent times. Our productive resources are extremely rich. (A) *Natural Resources*. Nature has been bountiful in her gifts to this country. In her diverse types of climate and variety of soils grow almost all the food products and raw materials, sufficient to feed a vast population and to support an extensive industrial structure. In the bowels of earth lie hidden vast quantities of metals and minerals which are our enviable national assets. We have rich forests and plentiful fisheries. (B) *Labour*. India is one of the most thickly populated countries in the world and possesses immense human labour. Since the standard of living is not high, wages are low. Of course, Indian labourers are not skilled since they do not receive any general or specialised training. But their mental equipment is active and they soon understand the work which is assigned to them. Consequently, in a properly organised economy of the country, labour difficulties will not be serious. (C) *Capital*. Our capital resources are increasing rapidly. We have been importing gold from times immemorial, which has remained in the country. It is only in recent years that we have exported some of our gold. Naturally, therefore, all this gold must be within the country. If our capital resources are not huge, it is due to the fact that a large part of our gold is kept in the shape of hoards and not converted into capital by its application to productive purposes. But under the spell of attractive rates of interest, systematic and vigorous propaganda and spread of education, a large part of this gold may one day be turned into capital and

there may not be any dearth of it. (D) *Organization*. In our country few people possess organizing ability. We have to import foreign personnel for our managerial staff. But Indians are going abroad for receiving training and experience in this branch and conditions might improve in course of time. (E) *Enterprise*. Though all other factors of production are present in our country, still our production is negligible and the majority of the population is poor. We are thus starving amidst plenty. An important reason of this paradox is that there is scarcity of enterprise in this country. If people come forward to take the risk involved in productive processes, our national dividend will go up and the income per head will rise along with it.

Reasons For Lack of Enterprise

Lack of enterprise is generally ascribed to the cowardice of our people which makes them afraid of undertaking a business risk. This allegation was very true in the past but it has now lost much of its force. As a matter of fact, whenever business men are sure of a sympathetic state attitude with regard to any new and profitable business line, plenty of enterprise appears in the field. In recent years as soon as protection was granted to the sugar industry in 1932, mills after mills were started and within the short span of three or four years, the country became almost self-sufficient in sugar. If enterprise lacks in any field, it is primarily due to the suspicious and unsympathetic policy of the Government with regard to that line. At the present moment industrialisation of India cannot take place, unless Government comes to its aid actively. Most of the countries of the world have already been industrialised and at present supply their goods to us. As soon as any new industry is started in this country, they sell their goods at very cheap rates and the new indigenous industry collapses. Our industries can flourish only when the Government gives them sufficient protection, i.e., imposes adequate import duties on foreign goods so as to check foreign competition side by side¹. In

1. See A. N. Agarwala, *Fresh Light on the Tariff Policy*, in *Industrial India*, November, 1939.

the early stage of economic development the State should also give technical and other assistance to entrepreneurs. If the State does its duty in right earnest in various spheres of production, there will be no lack of enterprise.

Scope For Enterprise

Our country is economically backward. No sphere of economic production is satisfactorily or sufficiently developed. The scope for enterprise is vast in all the fields. A comprehensive survey of the scope in India will cover volumes. We can do here no more than to make a rapid survey. Our discussion falls under the following heads: (i) Scope in extractive industries. (ii) Scope in manufacturing Industries. (iii) Scope in financial field. (iv) Scope in transport.

§ 1. SCOPE IN EXTRACTIVE INDUSTRIES

Agriculture

India is mainly an agricultural country. The percentage of her population depending upon agriculture is excessive; and the income accruing to cultivators from agriculture is poor. Hence it is generally taken for granted that there is no scope for enterprise in agriculture. Our young men in particular believe that it is barren of any possibilities. This is an entirely wrong notion. Agriculture is at present in the hands of uneducated and poor cultivators and is carried on in very crude ways. If educated men, with capital resources, up-to-date scientific knowledge and managerial ability, come in the field, they can make decent profits.

The field for new enterprise lies in three directions; (a) Our cultivators practise very primitive methods of cultivation, partly due to their poverty but more to their ignorance and conservatism. Resourceful and ambitious men have fair field for the application of up-to-date knowledge and capital resources in this sphere. (b) Extensive cultivation of land is also possible. New land can be reclaimed by draining marshes and clearing bushes and forests. Proper irrigation is likely to make much level land fertile. Entrepreneurs venturing

into this branch will find many profitable avenues of production. (c) The field for intensive cultivation of the western variety is also vast. Our cultivation is not at present mechanised and does not make use of recent advances in agricultural processes brought about by scientists. Large scale cultivation, use of threshers, motor ploughs, elevators, steam or electric locomotives etc., are still to come. Pioneers in this field may get chances of earning magnificent rewards.

Forestry

Our forests contain valuable raw materials of various types. Their major and minor produces can support a number of industries. For instance, *bhabar* and *sabai* grasses and bamboos can be used for producing paper. It can also support the lac and rubber industry. Turpentine, rosin and sandal-wood are other important products. But due to several reasons, already discussed, our forest industry is undeveloped. There is good scope for enterprise here.

There are various other extractive industries pregnant with great possibilities, e.g., fisheries and mining. Talented men will find ample scope for the application of their energies in these fields.

§ 2. SCOPE IN MANUFACTURING INDUSTRIES

It is in the manufacturing industries, however, that we find the greatest scope for enterprise. Our industries can be divided into three classes : (1) Industries which do not satisfy the national demand fully; (2) Industries which satisfy national demand fully but have no markets abroad; and (3) Industries which depend mainly on foreign markets. In each of these groups there is scope for enterprise.

A. Industries Which Do Not Meet National Demand Fully

Our industrial development being little, there are many industries which satisfy only a fraction of our demand, the rest being satisfied by imported goods. All such industries can expand at least to the limit of national demand.

Iron and Steel Industry—Let us first take the main key industry, i.e., the iron and steel industry. Our iron and steel industry has certainly made appreciable progress, but much room for further development still exists. We still depend almost entirely on foreign countries for all sorts of machinery, hardware goods etc. If an entrepreneur applies brain and energy in this branch and achieves success, his reward will be magnificent. The demand for such products is already vast; it is sure to increase with every step taken on the road of industrialisation and mechanisation.

Chemical Industries—What is true of the iron and steel industry applies to the chemical industry as well. Unfortunately, our chemical industry is not at all developed and we have to look to other countries for necessary chemicals. Raw materials for the development of this industry exist in our country and other facilities are also not lacking. During the last Great War, chemical industry was developed in India to supply the needs of the Allies, but it languished after the war when the Government withdrew its support. In the present War, the industry is again being set up and entrepreneurs might find it a profitable channel.

(c) *Cotton Textile Industry*—Next we come to the cotton textile industry which is one of the largest industries of the country. Indian mills and handlooms satisfy up $\frac{2}{3}$ or $\frac{3}{4}$ of our total demand, the rest being satisfied by goods imported from Japan, China and Great Britain. There is considerable room for the extension of this industry for satisfying home demand. Not only this; our mills can find markets even in neighbouring countries.

(d) *Leather*—In the agricultural economy of India, animals play an important part. Consequently, the supply of hides and skins is considerable. In fact, it can support an extensive leather industry. The present leather industry is mostly in the hands of ignorant *chamars*. They export partially tanned or untanned hides and skins to foreign countries where they are scientifically tanned and sent back to us.

Sometimes we import even leather goods. This drain of money can be checked if some enterprisers come forward and start leather factories on modern scientific lines.

(e) *Paper Industry*—We also import considerable quantities of paper from abroad. Some paper factories have been started in India recently and are working successfully, and there is a great scope for many more. Grasses and bamboos from which paper can be made are inexhaustible in supply; the demand is great and is increasing with increase in literacy. It is, as such, an attractive line for the application of enterprise.

(f) *Others*—The above industries by no means exhaust the list. There is a large number of similar industries which have not yet extended to the limit of national self-sufficiency and where the scope for enterprise is great.

B. Industries Meeting National Demand Almost Fully But Having No Foreign Markets

Such industries are only few, the most important of them being sugar industry. The sugar industry was given protection in 1932 and in 1936, it began to satisfy almost the entire home demand. The industry was overgrowing the national limit and bidding for foreign markets when unfortunately the Government of India agreed to the International Sugar Convention which forbade exports from India. This Convention is definitely against the interest of India. If this Convention is relaxed, the sugar industry will be able to capture many markets successfully. Moreover, it is in the interest of the British Empire that Great Britain should purchase sugar from India rather than from non-Empire countries; and it is high time when India should become the supplier of sugar to Britain. The scope for enterprise in this industry still exists but it has been artificially blocked at present by our Government.

C. Industries Exporting Goods Abroad

The jute industry is the only industry which is dependent mainly on foreign markets. We have the

monopoly of jute production and, as such, our supremacy in the world in this respect is great. But this supremacy is now being challenged. Some countries have ceased to purchase manufactured jute goods from us : they purchase instead raw jute and manufacture goods themselves. Others are trying to find a substitute for jute. America in particular in trying to do away with the use of jute sacks. Scope, therefore, exists for intelligent working along similar lines. But what is more important is the fact that this industry is in the hands of foreign capitalists and entrepreneurs. Indian entrepreneurs should try to displace their foreign competitors.

§ 3. SCOPE IN FINANCIAL LINES

Financial businesses also furnish fair scope for enterprise. Of these, insurance and banking are important.

Insurance

Insurance is becoming widely popular in this country and is likely to increase as people come to realise the value of insurance. At present out of the 379 insurance companies working in India, of which 232 are constituted in this country and the rest, abroad. Indian entrepreneurs can displace foreign concerns from this field. Again, as the demand for insurance is increasing rapidly, they can set up new offices to meet this demand. Finally, some Indian life offices have extended their operations outside India, mostly in British East Africa, Ceylon and States Settlement. Foreign markets can be exploited still further.

Banking

In banking again the scope for enterprise is great. Our foreign exchange business is entirely in the hands of foreign banks. There is not a single Indian exchange bank. The Central Bank of India, recently started one but the cut-throat competition of the foreign banks suffocated it. Apart from foreign exchange business, we do not have industrial banks and land mortgage banks. Even in commercial banking there is field for further extension. Our country is very

poorly supplied with banks and the scope for enterprise in this branch is definitely great.

§ 4. SCOPE IN TRANSPORT

Railways

We are not well supplied with facilities for transport. Even the railways, which are the most important means of transport, are inadequate. The interior of the country is not connected with any important railway station from market unless it be by *kutcha* roads. The scope for enterprise in this line is great.

Motor Transport

The urgency of more railways has been reduced due to the increase in motor transport. Motor transport has recently become important. The scope for its extension is vast since they can serve as cheap and efficient links between far-flung hamlets and busy towns. They can aid the exploitation of natural resources and the distribution of goods amongst consumers. As such, scope for motor transport is great. The manufacture of motor vehicles is equally profitable.

Ocean Transport

In the oceanic transport Indian enterprise is lacking to a deplorable degree, mainly due to the apathetic attitude of the Government. In 1924, only 13 P. C. of the Indian coastal trade and $\frac{1}{2}$ P. C. of the foreign oceanic trade of India was conducted by Indian ships. The share of Indian ships in the coastal trade has now increased to 25 per cent; but condition, is not much better. Considerable scope for enterprise still exists. Government should assist the growth of our shipping industry. Most of the maritime countries of the world reserve coastal shipping to national ships. The Mercantile Marine Committee of 1923 recommended the same for India but this recommendation was not accepted by the Government. Given proper help and Government support, this industry is bound to develop in our country.

PUBLIC FINANCE

Finance is not mere arithmetic finance is a great policy. Without sound finance, no sound government is possible without sound government, no sound finance is possible.

—Wilson.

CHAPTER I

THE DIVISIONS OF PUBLIC FINANCE

Public Finance is concerned with the income and expenditure of public authorities, and with the adjustment of the one to the other—Hugh Dalton.

Meaning of Public Finance

In every developed society, some form of Government organisation exists. Government has certain functions and duties to perform. These functions are either necessary or optional. The defence of the country against foreign aggressor, the maintenance of peace within the country and the enforcement of law for the punishment of evil-doers are necessary functions. In the case of optional functions, Government may undertake work for which its position as a central body and a large capitalist specially renders it suitable. It may provide a good currency and a uniform system of weights and measures, good roads and railways and efficient post offices and telegraphs. The more a Government plays the role of an educator, the more numerous its optional functions tend to become. All these functions involve expenditure, to meet which Government needs money. Therefore, it has to raise revenue. The science which studies the wealth-getting and wealth-spending activities of the State is known as Public Finance. As Findlay Shirras puts it, Public Finance is the science which is concerned with the manner in which public authorities obtain their income and spend it¹.

Divisions of Public Finance

Public Expenditure and Public Revenue are the two obvious branches of Public Finance. Sometimes the income of the State falls short of its revenue, and the Government has to borrow money. The problem of Public Debt is so important that it is studied as a separate branch of Public Finance. Finally, the finan-

1. Findlay Shirras, *The Science of Public Finance*, Volume I. Also see Pigou, *A Study of Public Finance*, p. 3, and Dalton, *Public Finance*, p. 1.

cial administration, involving the framing of budgets, auditing and the like, has also got to be studied, and Financial Administration emerges as the fourth branch of Public Finance. Public Revenue, Public Expenditure, Public Debt and Financial Administration are, then, the four divisions of Public Finance.

Public Expenditure

Scant attention was paid to Public Expenditure up to 19th century. It was only recently when increase in population, prices, standard of living and frequency and expenses of wars increased public expenditure enormously that it began to be studied as a separate branch of Public Finance. § 11.5

Public and Private Expenditure—The following are the points of difference between public and private expenditure, which are sometimes compared:—

(1) A private individual has his income, more or less, fixed in any particular time and he has to adjust his expenditure to it. The State, on the other hand, first finds out the probable expenditure of coming year and then adjusts its income to it. Secondly, a private individual thinks a surplus of income over expenditure a mark of wisdom, for that helps him in the proverbial "rainy days". But, in Public Finance, a surplus is bad since it shows that people have been taxed unnecessarily and also because a surplus makes State officials wasteful. The ideal of a finance minister is a small deficit which makes State officials careful in spending money. Thirdly, Public Expenditure is of a compulsory character. For instance, expenditure on defence must be incurred and interest on debt must be paid. But in private expenditure the will of the individual often determines the amounts and directions of its application.

Public Revenue

Writers on Public Finance have divided Public Revenue in a variety of ways. Without going in detail, we point out below the main sources of revenue of the modern State:—

(1) Public Domain—Government is the direct owner of certain land, forests, and mines; and receives a revenue therefrom.

(2) Fines and Gifts—Sometimes the State charges a penalty from the offenders of the law. These fines are not levied primarily with the object of deriving a revenue. Nevertheless, they are as good as any other source of income. Sometimes some rich persons voluntarily give some donations to the State for humanitarian objects.

(3) Rate or Price—The modern State carries on certain enterprises like post office, railways etc. The price paid by the purchasers of the goods or services sold by these enterprises, is a source of income of the State. When you buy a postcard, you pay nine pies as its price. A rate or price has been defined as a payment made by an individual for a service or commodity sold by the Government.

(4) Taxes, Fees and Special Assessments—The above sources of income do not yield sufficient revenue. The main sources of income of the State are the taxes, fees and special assessments.

A tax is, "a compulsory contribution to the Government to defray the expenses incurred in the common interest of all, without reference to special benefit conferred". Tax differs from price in the sense that, firstly, tax is compulsory while price is voluntary and, secondly, the payer of price is directly benefited while the tax-payer may not be benefited directly and proportionately. For instance, if a rich man pays Rs. 5,000 per month as tax, he might get only a little benefit in return in the shape of security of life and property; while the rest of the money might be spent by the State on the improvement of the "slums"; but if he purchases ten envelopes, he receives full value for what he pays. As Prof. Taussig puts it, "the essence of a tax is the absence of a direct *quid pro quo* between the tax payer and public authority."

We sometimes pay fee to the State, e. g., court fees and stamp fees. Fee has been defined as a pay-

ment to defray the cost of each recurring service undertaken by the State primarily in the public interest but conferring a measurably special advantage on the fee-payer.

Sometimes an improvement is affected by the State in the public interest but those who benefit by it are charged in proportion to the benefit conferred. For instance, a road might be improved and the expenses collected in the shape of *special assessments* from those who directly benefit by it. It is American in its origin and application. It has been defined as a compulsory contribution levied in proportion to the special benefit derived to defray the cost of public improvement to property undertaken in the public interest.

CHAPTER II

TAXATION

As a Government ought to make no distinction of persons or classes in the strength of their claims on it whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all which it must be observed, is the mode by which least sacrifice is occasioned on the whole—*John Stuart Mill*,

Taxation is considered to be the most important part of the Science of Public Finance. Taxation is one of the sources of income of the Government and is thus merely a fraction of the whole science.

§ 1. CANONS OR PRINCIPLES OF TAXATION

The qualities desirable in a system of taxation have been embodied by Adam Smith in four canons or principles¹. Subsequent writers have generally followed and adopted them and they have now become classical. They are stated below :

(1) *Principle of Equality or Equity*—"The subjects of every State ought to contribute to the support of Government, as nearly as possible, in proportion to their respective abilities, i.e., in proportion to the revenue which they respectively enjoy under the protection of the State. In the observation or neglect of this maximum consists what is called the equality or inequality of taxation".

✓ This principle, known as the principle of equity, discusses the lines of levying taxes equitably. It is generally agreed upon that contributions collected by the State from its members should be such as to inflict equal sacrifice on each of them. According to Adam Smith, principle of equal sacrifice will be put into practice if taxes are collected in proportion to the incomes of the members of the State. Such taxation is known as Proportional Taxation. Adam Smith finds probably few followers to-day. Modern economists generally maintain that equality of sacrifice can be brought about if the rich pay more

1. Adam Smith. *Wealth of Nations*, book II, Chapter II, sec. 2

than proportionate to their income and the poor less than that proportion. Such taxation is known as *Progressive Taxation*; and is coming widely into popularity.

(2) *Principle of Certainty*—The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person. This statement is so clearly worded as to require no explanation. Certainty implies absence of speculation in the finances of the State and the discouragement of arbitrary exactions on the part of tax-gatherers².

(3) *Principles of Convenience*—"Every tax ought to be levied at the time or in the manner, in which it is most likely to be convenient for the contributor to pay it. A tax upon the rent of land or houses payable at the same time at which such rents are usually paid, is levied at a time when it is most likely to be convenient for the contributor to pay; or when he is most likely to have wherewithal to pay." The greater the convenience to the tax-payer, the less the time and resources involved in the collection and payment of taxes. Taxes on commodities, called indirect taxes, are very convenient since they are paid by the consumer in a manner that is convenient to him. He pays them little by little as he has occasion to buy goods.

(4) *Principle of Economy*—"Every tax ought to be so contrived as to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State." This principle means that those taxes should be given preference whose cost of collection is less in proportion to their yield and which cause least injury to the economic interest of the tax payers. For instance, if the collection of a tax requires the

2. Adam Smith wrote, "the certainty of what individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil, as a very small degree of uncertainty".

services of an army of the collectors whose activities cause the tax-payers to stop business for some time, the cost incurred by the State and the injury inflicted on the tax-payers will be so great as to constitute a flagrant violation of the principle of economy.

Modern Additions to The Above Principles—Modern writers have added three more principles to the above four Adam Smithian principles of taxation.

(5) *Principle of Productivity*—This principle implies that a tax should be productive of handsome yield. The imposition of several taxes yielding small proceeds causes great vexation and inconvenience. It is better to impose only one tax which can produce large return.

(6) *Principle of Elasticity*—An ideal system of taxation should consist of some taxes whose income might automatically increase with an increase in wealth and population, or can be made to increase to meet sudden or exceptional demand for revenue without necessitating considerable increase in the cost of collection. Income tax is an ideal tax from this point of view.

(7) *Principle of Simplicity*—A system of taxation should be simple, plain and intelligible to the masses.

§ 2. DIRECT AND INDIRECT TAXES

Meaning

Taxes are either direct or indirect. "A direct tax is one which is demanded from the very person who, it is intended, or desired, should pay it." Income tax is a direct tax; it is collected from persons earning incomes beyond a certain minimum, and they cannot pass it on to others. Similarly inheritance tax is collected from the inheritor at the time the property is inherited, and he cannot shift it on to anybody else.

"Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of

another"³. For instance, when an importer imports sugar or cigarettes he is charged an import duty. It is not intended that he himself will bear its burden, but that he will recover the amount so paid from consumers by means of an advance in price.

Sometimes a direct tax is passed on to other persons. For instance, a business man paying income tax may enhance the prices of goods sold by him with a view to recover the amount paid as tax. But this will not make it an indirect tax. It is the intention of levying the tax which decides whether it is direct or indirect; and in the present case the intention was that the tax payer should bear its burden.

The Advantages of Direct Taxes

The advantage of direct taxes, like income tax, inheritance tax, land tax etc., are the following :—

(1) *They are economical*—A direct tax is paid by the ultimate tax-payer to the State; as such the cost of collection is small.

(2) *They are certain*—The tax-payer knows what exactly he has to pay and the State authorities know what they have actually to receive.

(3) *They are equitable*—The person on whom the burden finally falls can be generally definitely ascertained and the rate of payment easily proportioned so as to equalise sacrifice.

(4) *They are elastic*—Direct taxes can be easily increased to meet emergent demand on the State purse. Moreover, their proceeds automatically increase as wealth and population increase. The various adjustments and amendments made in the Indian Income Tax Act to suit the varying needs of the Government illustrate this point fairly well.

(5) *They arouse civil consciousness*—When a man pays direct taxes, he feels that he is contributing something towards the maintenance of the State, and he naturally tries to understand whether his money is being properly utilised or not.

3. J. S. Mill, *Principles of Political Economy*, Bk. V, Ch. 3, § 1.

The Disadvantages of Direct Taxes

(1) *They are sometimes very inconvenient*—For instance, an income tax-payer has to keep an elaborate system of accounts to suit the whims of tax-gatherers and to fill up a detailed statement, both of which cause considerable inconvenience. Sometimes the time of payment is also unsuitable.

(2) *They are tried to be evaded*—An income-tax payer, in order to escape taxation, gives wrong statements. Such cases arise almost every day. Direct taxes have, therefore, been called taxes on honesty.

(3) The basis of assessment is arbitrary and, therefore, the likelihood of doing injustice to certain sections of community, is great.

The Advantages of Indirect Taxes

Indirect taxes possess the following advantages:—

(1) *They are very convenient*—They are mixed up with the prices of commodities and the purchasers do not feel that they are paying any tax. Moreover, the tax is paid little by little as purchases are made. Finally, as the consumer is at liberty either to buy or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniences from such taxes.

(2) *They can be collected from even the poorer section of community*—It is the principle of Statecraft that each member of the State should pay something, howsoever little, towards the maintenance of the State. It is generally the indirect taxes which make it possible.

(3) *Some of them are elastic*—Taxes levied on articles of necessities are very elastic; since the demand for such articles remains almost the same in spite of an increase in price due to the imposition of an extra tax, the yield increases if the rate of tax is pushed up. But if the elasticity of demand for the article taxed is great, an increase in tax is accompanied with a fall in the yield.

(4) *They cannot be easily evaded*—Because they are included in the price of articles which cannot be had unless the price is paid, their evasion is not possible.

(5) Sometimes they are levied on intoxicating liquors and drugs and similar articles and *do a distinct social service* by restricting their consumption.

The Disadvantages of Indirect Taxes

(1) *They are inequitable*—The rich or the poor, whoever purchases the article, has to pay the same price. As such, the poor have to make greater sacrifice than the rich.

(2) *They are uneconomical*—Usually some middlemen intervene between the ultimate tax-payer and the State, and they can easily increase the price of the goods taxed beyond what is justified by the rate of the tax.

(3) Since the payer of indirect taxes does not feel that he is paying a tax, his *civic consciousness* is *not stimulated* and he is not led to take a keen interest in the matters of the State.

(4) *These taxes are uncertain*—The actual extent of consumption and, therefore, the ultimate yield, cannot be definitely anticipated.

(5) As shown above, some indirect taxes are *inelastic*.

Direct Taxes Versus Indirect Taxes

Sometimes the advantages and disadvantages of direct and indirect taxes are compared in order to find out which is the better of the two. Such attempts are not of much practical value. Each of them has advantages and disadvantages and they cannot be weighed in the balance to draw definite conclusion in favour or against either of them. In any taxation system, both kinds of taxes must be present; they are like the two legs of a man each of which is necessary for walking. In the famous words of Gladstone, they are like two attractive sisters and it is the duty of every finance minister to pay his respects to both of them.

1 *The Case of India*—The quest becomes a proper one if it is posed in a slightly different way. We may well ask : Should a particular country impose direct, or indirect taxes to increase the State revenue equitably or to make the taxation system just ? The answer will naturally depend upon the conditions prevailing in each country. Let us take the case of India. Our tax system is not well-balanced. It relies unduly upon indirect taxes, mainly because they are not felt by the payers. Indirect taxes, as already said, fall more severely on the poor than on the rich. Most of our important sources of income are indirect taxes like excise duties, customs duties etc. The only important direct tax is income tax. Consequently, in order to make our system well-balanced and ethically just, more direct taxes should be introduced.

CHAPTER III

PUBLIC FINANCE IN INDIA—CENTRAL FINANCE

We do not object to the fire being kept up, but to the absence of any cooking pot over it. And when the cost of the blaze becomes so exorbitant as to leave nothing over to fill the pot with, then, if in answer to the tears which spring from the gnawing emptiness within, the question is thundered against us, 'Are we not, then, to light up your hearth?', we have to falter back, "Yes, yes no doubt, but not for our cremation, please"—*Rabindra Nath Tagore* (On Defence Expenditure)

§ 1. INDIAN PUBLIC FINANCE

Public finance in India is the concern of three separate authorities, (i) the Government of India, whose finance is known as the Central or Federal Finance; (ii) Provincial Governments, whose finance is called Provincial Finance; and (iii) Local Bodies like Municipalities and District Boards, whose finance bears the designation of Local Finance.

The annual revenue and expenditure of the Government of India comes to Rs 120 crores approximately. The Central Finance is the most important in magnitude. The total annual revenue and expenditure of all the Provincial Governments put together come to about Rs. 100 crores. The annual income and expenditure of all the district and local boards in British India come to about 20 crores of rupees; and of all the municipalities together, to about Rs. 40 crores. The following diagram illustrates

the aggregate and individual magnitude of these finances :—

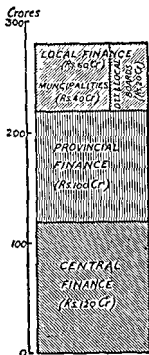


Diagram showing the Magnitude and Divisions of Public Finance in India.

Under the new Constitution of 1935, Provincial Governments enjoy considerable autonomy in all matters including financial. This was not the case about a century back. According to the Charter Act of 1833, the Imperial system of Government was introduced in India and thorough centralisation in finance was established. From that year forward, all the revenues in all parts of the territory began to be collected in the name of Central Government and all expenditure, made in the name of the same body. With the passage of time the defects of this type of extreme centralisation was realised and de-centralisation was slowly evolved. The Constitutions of 1919

and that of 1935 have been remarkable in this respect¹.

§ 2. FINANCES OF THE GOVERNMENT OF INDIA

Heads of Central Revenue

The following is an account of the chief heads of revenue of the Government of India :

(1) *Customs*—Taxes on duties levied on the goods exported from or imported into, a country are known as custom duties. A list of such duties is known as tariff. The duties levied on imports are known as *import duties* and those levied on export, *export duties*.

Custom duties bring to the Government of India about 55 crores of rupees. Thus they constitute little less than 50% of the entire revenue of the Central Government. Their importance in the Central Finance can, therefore, be easily appreciated.

Before the War, our tariff policy was based on *free trade theory*, i.e., the policy of allowing free imports and exports without imposing prohibitive export and import duties. The custom duties, such as they were, were fairly low and were not intended to check foreign trade but simply to collect revenue. Such duties were called revenue duties. During and after the War, the Government were in need of funds and these duties were considerably increased. Still later, the Government changed their tariff policy from free trade to protectionism, i.e., the policy of protecting Indian industries by imposing heavy duties on competitive imports. Such duties are known as protective duties. The adoption of this policy increased import duties on several commodities fairly high and the customs revenue increased.

1. For a thorough study of the evolution of decentralisation in Indian Finance, See Gyan Chand, *The Essentials of Federal Finance*, B. P. Adarkar, *Principles of Federal Finance*, Banerji, *Provincial Finance in India*, Ambedkar, *Provincial Finance in British India*, K. T. Shah, *Federal Finance in India*, etc. For a rapid survey of its early history, see Amar Narain Agarwala, *The Evolution of decentralisation in Indian Finance in the Indian Journal of Economics*, Volume 19, Part III.

Custom duties may be *ad valorem* or *specific*. *Ad valorem* duties are charged according to the value of the goods and are often expressed as a percentage of their price. Specific duties, on the other hand, are fixed charges calculated according to the number, volume, weight or measure of the commodity. Most of the duties in India are *ad valorem*.

(2) *Income Tax*—Income tax is the next important source of income, bringing to the Central Government about 15 to 20 crores of rupees. Income tax is levied on incomes crossing a certain limit. It was first introduced in India in 1860 under the financial stringency caused by the Mutiny. Since then it has had a very long and chequered history. At present the rates² of income tax are as below.—

Annual Income		Rate per rupee
Less than Rs.	2,000	nil
Rs. 2,000 to Rs.	5,000	6 pies.
5,000 ..	10,000	9 ..
10,000 ..	15,000	1 anna.
15,000 ..	20,000	1 anna 4 pies.
20,000 ..	30,000	1 anna 7 ..
30,000 ..	40,000	1 anna 11 ..
40,000 ..	1,00,000	2 annas 1 ..
Above ..	1,00,000	2 annas 2 ..

Besides income tax, super tax is also charged on incomes above 30,000 rupees at various rates of interest.

Income tax is a direct tax and, as such, it has the merits and demerits of such taxes. Generally speaking, its *advantages* are that it can be equitably levied since its incidence can be definitely known. Again, it is elastic, its yield increasing with little manipulation or with an increase in the wealth and population. It is also certain and economical and arouses civic consciousness. Its *demerits* are also obvious. It is a tax on honesty and attempts are often made to evade it by keeping false accounts and otherwise. It

2. Vide the Finance Act of March 1938.

is also inconvenient as the filling up of forms and the maintenance of proper accounts involve trouble. It is not paid by the poor sects of communities and if the rates are increased very much, it discourages savings.

The main points of criticism of the Indian Income Tax in its present shape are that it does not take into account the size of the family; it unjustly exempts agricultural income from its scope; and it does not discriminate between earned or unearned increment.

(3) *Salt Tax*—The salt revenue was inherited by the Britishers from their predecessors. It produces an annual yield of about 8 crore rupees. Salt tax is the most unpopular tax in India. The people resent it very much, so much so that Mahatma Gandhi made the non-payment of salt tax on the manufacture of salt a core of his Civil Disobedience Movement. It is criticised on the following grounds: (i) Salt is necessary for existence and, in principle, it is bad to tax a necessity. This tax has the evil effect of decreasing the consumption of salt by people and cattle, which tells upon their health. (ii) This tax has to be paid by the poorest, whose poverty makes it very burdensome. It becomes all the more harsh because they have to pay a number of other taxes as well. Like the last straw that breaks the camel's back, it is breaking the back of the poor cultivators. (iii) This tax is inequitable. The poor consume more salt than the rich and have to pay a larger amount; (iv) Finally, there is the consideration that the tax is being levied against the express wish of the people and is, therefore, bad.

Government of India have long adhered to this tax on various grounds: (1) This tax is the only means of reaching the masses of the country, so poor as ours. Sound administration requires that every member of the State should contribute something towards its upkeep. (2) It is an indirect tax and is, therefore, not felt by the people. (3) It is an old tax and an old tax is no tax, since by sheer habit people cease to think as a hardship. (4) Final-

ly, the burden per head of this tax is very small. Rupees crores are collected from 35 crores of people; the average coming to nearly 3 annas per head. (5) Government cannot afford to lose this sum in these days of financial stringency.

(4) *Opium*—The production and sale of opium has been the monopoly of the Government from very olden times. Formerly, opium was exported in large quantities to China and was a source of income of about 25 crores of rupees per year. But now exports to China have been stopped. It has dropped down to the insignificant figure of a few crores. In 1908 a section of the British public did not think it proper for the Indian Government to make profit at the expense of the morals of the Chinese people and the Government of India in that year undertook to reduce gradually the exports of opium to China, to become finally extinct in 1917. The export of opium, except for medicinal or experimental purposes, has now stopped. But the Chinese are, at present, addicted to opium to the same extent as before. Thus we have lost about rupees 25 crores on mere sentimental grounds.

(5) *Excise Duties on Sugar and Matches*—Excise duties are imposed on the production of certain goods within the country. Dr. Johnson defined excise as, "a hateful tax on commodities", a description which suits them very well, though not in all cases. The Government of India have imposed excise duties on the production of various commodities within the country from time to time and have been severely criticised for their action. Once they levied excise duty on cotton manufactures which aroused much opposition and had to be ultimately withdrawn. At present, there are two important excise duties on matches and sugar. The public had expressed their voice against an excise on sugar. In their opinion, the sugar industry has not yet consolidated its position; and this duty will reduce its competitive strength against foreign producers. The immediate effect of this levy has been shrinking profits and in some cases their conversion in losses, a deve-

lopment which has discouraged the industry considerably. The Government, on the other hand, feel that a stage has now come when the Industry can bear the burden of the excise duty. Its yield will make up the loss in the customs which they suffer because of insignificant imports of sugar. Finally, such a duty will induce the industrialists to improve their methods of production and to consolidate their position. The above remarks apply in a broad sense to the match industry as well.

(6) *State Enterprises*—Government also derive revenue from their enterprises like railways, irrigation and posts and telegraphs. In recent depression, the income from these sources was considerably dried up and in many cases actual losses have been incurred, particularly in railways. Recently, however, the condition has somewhat improved.

§ 3. HEADS OF CENTRAL EXPENDITURE

The chief items of expenditure of the Government of India are given below in order of their importance. The relative importance of items slightly changes from year to year.

(1) *Military Services*—Military charges consume in normal year nearly half of the entire revenues of the Government of India. Rs. 50 to 60 crores are normally spent on this head. As Sir Walter Layton observed, "An outstanding feature (of the public finance of India) is the high proportion ($62\frac{1}{2}\%$) which current expenditure on defence bears to the total expenditure of the central Government—a higher proportion, in fact, than in any other country in the world..... It is more significant even when account is taken of provincial and central finances together; the ratio ($31\frac{1}{2}\%$) is still a very high one". Further, observes Sir Walter, "the total is at present so large, both absolutely and in relation to the revenues of India, as to be a dominant factor in financial situation"⁴.

3. This is an old figure

4. See Simon Commission Report.

The enormous defence expenditure is admittedly too high for a poor country like India and there is scope for its *reduction*. Much *economy* can also be effected in the existing expenditure without impairing the efficiency of the national defence of the country by such means as reduction in the strength of the British element in the army, basing all salaries on the Indian standard and reduction in the strength of the standing army. The expenditure on national defence has tremendously increased recently due to the outbreak of the War and the problem now is not of the enormity of expenditure but of the best utilization of the enormous sum devoted to this purpose.

(2) *Railways*—About one-quarter of the total revenues is spent on railways. It takes the shape of interest on the debt incurred for railway purposes, subsidies, reserve, etc.

Expenditure on such items as railways, post and telegraphs etc. is said to have been incurred on *commercial services*. These services are of national importance and because private enterprise does not come forward to provide them, the State has to undertake the work upon its own shoulders.

(3) *Debt Services*—Expenditure incurred in respect to debt services comes to about 15 crores of rupees and roughly to 10% of the entire expenditure. It includes interest paid on ordinary debt and other obligations and the amount spent by way of reduction or avoidance of debt. Charges on this account, though large, are not, in fact, a matter of concern. The reason is that out of Rs. 1,000 crores of total debt, approximately Rs. 800 crores is productive and yields revenue to the State. Unfortunately, a large part of the debt has been raised in Great Britain in the form of Sterling loans and we have to pay a big sum to foreigners as interest. This could have been avoided had the loans been raised in India rather than in Britain.

(4) *Civil Administration*—The amount spent on civil administration exceeds Rs. 10 crores. It includes expenditure on (1) Administration and the maintenance

of peace and order and General administration just as police and jails, all come under this head. (2) Moral and material development of non-commercial nature. Education, medicines, public health, agriculture and industries, all come under this category. They are technically called "national building departments".

The major portion of the money spent on Civil Administration goes towards general administration and very little towards "national building departments". The latter are, unfortunately, being starved of funds. The administration of the country is generally good. Indian civil servants are, in particular, celebrated for their efficiency; they are often called the "steel frame." But they are the most highly paid officials in the world and are extremely expensive for a poor country like India. They are, in fact, too much efficient for us.

(5) *Direct Demands on Revenues*—They consist of the expenditure incurred in the collection of revenue like customs, income tax, salt tax, etc. This expenditure is unavoidable but there is ample room for economy.

Income of Central Govt. in 1936-37

Heads of revenue		Thousands of Rs
Principal Heads of revenue—		
Customs	...	53,57,51
Taxes on Income	...	15,33,51
Salt	...	8,81,36
Opium	...	47,66
Land Revenue	...	17,42
Excise	...	38,70
Stamps	...	39,00
Forests	...	14,81
Registration	...	1,14
Payments from Indian States	...	73,92
Scheduled Taxes	...	...
Total		80,05,03
Railways (net receipts)	...	32,68,56
Irrigation (net receipts)	...	—5,65
Posts and Telegraphs (net receipts)	...	93,36
Interest (Debt Services)	...	40,29
Civil Administration	...	1,03,56
Currency and Mint	...	1,18,71
Civil Works	...	31,38
Miscellaneous	...	96,57
Military Receipts	...	5,22,26
Miscellaneous adjustments between Central and Provincial Governments		—4,90,75
Extraordinary Items—		...
Extraordinary Receipts	...	67
Transfers from Revenue Fund	...	...
Total		67
Total Revenue		1,17,83,89

Expenditure of Central Govt. in 1936-37.

Heads of Expenditure			Thousands of Rupees
Direct demands on revenue	...	...	4,27,12
Forest and other capital outlay charged to Revenue	...	...	83
Railway Revenue Account—			
(Interest on debt, subsidies, Reserve, etc.)	...	...	32,68,67
Irrigation, etc.—			
Revenue Account	...	...	9,64
Capital Account charged to Revenue	...	...	15
Posts and Telegraphs—			
Revenue Account	...	...	78,82
Capital Account charged to Revenue	...	...	3,58
Debt Services—			
Interest on Ordinary Debt	...	...	35,66 13
Deduct—Amount chargeable to Railways	...	...	29,61,83
" " Irrigation	...	...	7,67
" " Posts and Telegraphs	...	...	79,28
" " Forests	...	...	69
" " Provincial Loans Fund	...	...	7,96,74
" " Provincial Governments	...	...	7
" " Salt Department	...	...	4,09
" " Hydro-Electric Schemes	...	...	...
" " Other Government Commercial Undertakings	...	...	2,80
Road Development Account	...	...	...
Remainder chargeable to Ordinary Debt	...	...	—2,87,04
Interest on other obligations	...	...	12,42 92
Reduction or Avoidance of Debt	...	...	3,00,00
Total Debt Services			12,55,88
Civil Administration—			
General Administration	..	...	1,80,49
Audit	...	...	1,09,14
Administration of Justice	...	...	800
Jails, etc	...	...	22 83
Police	...	...	55,12
Ports and Pilgrimage, etc.,	...	...	26,61
Lighthouses and Lightships	...	...	9,63
Ecclesiastical	...	...	29,78
Political	...	...	1,78,90
Frontier Watch and Ward	...	...	2,19,43
Scientific Departments	...	...	73,60
Education	...	...	30,32
Medical	...	...	26,31
Public Health	...	...	21,04
Agriculture	...	...	43,67
Industries	...	...	8,17
Aviation	...	...	21,78
Miscellaneous Departments	...	...	21,17
Indian Stores Department	...	...	22,25
Total			11,13,28
Civil Administration—			
Capital outlay on Industrial Development charged to Revenue	...	...	...
Currency and Mint—			
Currency	...	...	18 62
Mint	...	...	19,09
Total			37,71

Heads of revenue		Thousands of rupees
Civil Works—		
Civil Works	...	2,61 65
Bombay Development Scheme	...	..
Interest on capital on Hydro-Electric schemes	...	..
Total	...	2,61,55
Capital outlay on civil works charged to Revenue		..
Miscellaneous—		
Famine Relief	...	6
Transfers to Famine Relief Fund	...	...
Pensions, etc.	..	2,82,71
Miscellaneous	...	1 41,00
Total	...	4,13,83
Commutated pensions	...	6,07
Military Services	...	60 67,25
Extraordinary	...	19,23
Grand Total	...	1,19,62 61

CHAPTER IV

PROVINCIAL FINANCE IN INDIA.

Under the new Constitution of 1935, provinces have been given financial autonomy. Certain sources of income have been specifically assigned to them and certain heads of expenditure left to their care. In the division of the sources of income and the items of expenditure between the Government of India and Provincial Governments, much favour has been shown to the former. The Government of India have been given all the elastic sources of income while the items of their expenditure are inelastic. The case of Provincial Governments is just the reverse: their sources of income are land revenue, stamps, forests etc., which are not likely to increase; but their expenditure on objects like nation building departments, irrigation etc., is ever increasing. Requiring the Provincial Governments to finance elastic items of expenditure with inelastic resources, is one of the most fundamental weaknesses of the present Constitution.

§ 1. SOURCES OF PROVINCIAL INCOME

The chief sources of Provincial Income are the following:—

Heads of revenue	lacs of rupees (1936—37)
1. Land Revenue	31.71
2. Excise	14.99
3. Stamps	11.49
4. Forest	4.25
5. Registration	1.17
6. Others	60
	<hr/>
Total ...	64.21
Irrigation	9.95
Civil Administration	6.22
Others	11.96
	<hr/>
Total revenue ...	92.34
	<hr/>

The importance of each head varies from province to province as is clear from the Appendices to this Chapter. We shall deal with the various heads of revenue with special reference to the United Provinces.

(1) Land Revenue

Land revenue had been till very recently the mainstay of the Central Finance. It is now the biggest source of income of the provinces and is the only source of direct taxation for them. It is important in the United Provinces, Central Provinces, Punjab etc., but not in Bengal where it is fixed for ever. In the United Provinces, about 45% of the total revenue comes in the shape of land revenue.

Land revenue as a piece of taxation offends against most of the principles of taxation. It is definitely inelastic. In 1913-14, its total yield in India was Rs. 32 crores; in 1934-35 that figure rose to Rs. 34 crores; and in 1936-37 it fell to Rs. 32 crores. Secondly, it is very inconvenient and rigid. When there is a failure of crops, some relief is certainly given to cultivators by remitting assessment, but it is a hard fact that the rigidity with which land revenue is collected drives a large number of people to the moneylender during bad seasons. Long periods of settlement and the meticulous enquiry by a large staff at the time of settlement cause much inconvenience. Thirdly, it is uneconomic. India possesses the most elaborate revenue survey in the world involving enormous expenditure. Finally, as Dr. Gregory has stated, "the land revenue is essentially a tax on things and not on persons; and, consequently, it is charged in equal amount whether the payer is rich or poor. As such, it requires more sacrifice on the part of the poor than on the rich."¹

(2) *Excise*—The excise revenue in the provinces is derived from the manufacture and sale of intoxicating liquors and drugs, hemp and opium, and other intoxicants. It is charged in the form of a duty on the

1. See *Indian Taxation Enquiry Committee Report, 1934-35, Volume I, Chapter 4.*

manufacture of intoxicants and fees for the licenses permitting their sale. There is a growing volume of opinion in the country that high excise duties should be levied so as to do away with the drink habit gradually. The Simon Commission observed that the doctrine of maximum revenue and minimum consumption is the theory generally accepted in the Provinces but it is not always easy to hit this point with precision; and excise revenue is likely to be reduced not merely by prohibition and propaganda but by smuggling and evasion. In recent years excise revenue has rapidly declined. It decreased still further under the regime of the Congress Governments which adopted the prohibition policy. In the United Provinces the income from this head is only 8% of the total revenue and is likely to decrease still further.

(3) *Stamps*—Provincial Governments obtain income by the sale of stamps as well. These stamps are not the postal stamps but those which are (i) placed on commercial documents and (ii) purchased as court fees. They yield in the United Provinces about 10% of the total income.

(4) *Irrigation*—Canals are under the Provincial Governments, which charge water rates from the cultivators in exchange for water taken by them from canals for irrigation purposes. In the United Provinces the income from canals comes to about 8% of the total revenue.

(5) *Forests*—The Provincial Governments gain much from the sale of timber and other forest produce, grazing fees and license fees for permission to cut wood, etc. The revenue from forests is not large at present, but can increase considerably if huge initial expenditure is incurred, which is not possible in immediate future.

(6) *Civil Administration*—Income from Civil Administration includes the receipts from the departments of justice, police, jail, education, medical, industries etc. It is not important in the United Provinces.

(7) *Registration*—Fees are charged for the registration of legal documents and for their copies. This is another unimportant source of revenue.

(8) *The Scheduled Taxes*—There are certain taxes which the Provinces can levy if they so like. They have not been very much utilised so far. Bengal, Bombay and Madras have imposed betting and amusement taxes, while in the United Provinces, the Congress Government imposed an entertainment tax which is still in force.

The merits and demerits of the entertainment tax are as follows. Its merits are: (1) *It is equitable.* It is generally paid by the rich, who have broad shoulders to bear its burden. (2) *It is easy to be collected, e.g.,* in the form of an extra charge on cinema tickets and passes. (3) It is a good tax for increasing the revenue of Governments in the days of financial hardship. Its demerits are: (a) It is not certain. (b) It is not very elastic. (c) It is not convenient. (d) When levied on the poor, it involves hardship.

§ 2. HEADS OF PROVINCIAL EXPENDITURE

The following are the important heads of expenditure of Provincial Governments in India

Heads of expenditure	lacs of rupees (1936—37)
1. Civil Administration	52.42
2. Civil Works	8.98
3. Direct demand on revenue	8.69
4. Irrigation	7.09
Total Expenditure	91.55

The importance of each head of expenditure varies from province to province and can be found out from the Appendix at the end of the Chapter. Here we make a rapid survey of various expenditures with special reference to the United Provinces.

(1) *Civil Administration*—This is the most important item of expenditure in the United Provinces and absorbs about 45% of the total revenue.

As in the case of the Government of India, this expenditure is divisible into (1) Expenditure on General Administration like justice, police and jails and (2) that on Nation Building Departments like education and public health etc. General Administration is so costly that adequate amount is not found for the Nation Building Departments which suffer from scarcity of funds. Efforts should be made to make as much economy as possible in the expenditure on general administration by a policy of vigorous Indianisation and reduction in the scale of salaries to the Indian standard, and so on. More funds should be found for developmental purposes like education, sanitation, agriculture and industry. Of all these problems, that of education is the most important.

(2) *Direct Demands on Revenue*—This includes expenditure incurred in collecting taxes and obtaining other revenues like excise duties, registration fees, collection of land revenue, etc. This expenditure claims about 10% of the total revenue in the United Provinces. Considerable room for economy exists and should be practised.

(3) *Irrigation*—A major part of expenditure under this head goes in paying interest in borrowed money with which irrigation works have been constructed. A certain amount is also spent for constructional purposes.

(4) *Public Works*—This includes the amount spent on education and maintenance of public buildings and roads.

(5) *Debt Services*—Some amount is paid towards the interest for the loans incurred and towards the creation of reserve and avoidance of debts.



Revenue of the Several Provincial Governments for the year Ended 31 March 1937

In Lakhs of rupees

Heads of revenue	Madras	Bombay	Bengal	United Provinces	Punjab	Burma	Bihar	Central Provinces and Berar	North-West Frontier Province	Assam	Orissa	Sind	Total Provincial Government
Principal heads of revenue—													
Taxes on income	...	...	...	...	...	...	0.27	...	...	3.16	0.57	...	3.73
Salt	...	0.02	0.55	0.01	...	1.07	1.36 14	2.54 45	21.67	0.06	0.02	...	2.00
Land revenue	4.65 59	3.44 12	3.54 00	5.64 69	2.96 74	5.05 70	1.16 10	63.80	9.09	1.29 76	50.26	40.57	31.71 13
Excise	3.95 58	3.25 29	1.36 35	1.52 78	1.03 58	89.52	97.34	50.22	8.14	35.90	32.78	34.95	14.98 52
Stamps	1.95 05	1.46 99	3.02 35	1.62 59	89.85	41.67	5.65	47.64	4.36	18.29	17.32	18.85	11.49 44
Forest	48.29	47.72	18.36	44.36	22.46	1.42 64	12.69	4.94	0.68	18.85	4.28	7.28	4.25 20
Registration	30.69	15.04	23.97	10.35	9.31	3.38	...	0.03	...	1.63	2.14	2.01	1.16 91
Scheduled taxes	0.82	19.72	16.89	...	0.43	14.13	...	...	...	...	...	1.06	53.84
Total ...	11,36.05	8,99.10	8,52.48	9,34.78	5,22.38	7,98.11	3,68.19	4,21.08	43.94	2,05.65	1,07.37	1,04.72	64,20.77
Railways	...	...	0.38	1.04	4.41 83	32.17	21.95	4.21	12.51	...	4.16	89.95	1.42
Irrigation	2.16 10	20.06	-0.31	1.51 85	9.34	2.42	6.96	3.95	0.73	0.44	0.28	3.70	9.94 64
Debt services	25.18	93.14	7.20	11.93	74.31	49.11	32.23	23.40	10.24	13.84	4.87	11.18	1.65 52
Civil administration	1,26.16	1,29.01	94.37	51.59	32.32	23.27	10.39	13.01	5.85	21.93	1.50	3.37	6,22.49
Civil works	37.43	38.81	20.90	22.15	46.88	23.97	18.21	5.04	1,02.06	11.52	52.18	1,87.43	2,33.75
Miscellaneous	17.12	59.45	2,39.37	18.66	...	...	...	...	...	...	...	...	7,95.18
Total Revenue ...	15,58.04	12,39.80	12,14.39	1,92.00	11,27.06	9,29.05	4,57.93	4,70.72	1,75.33	2,53.38	1,70.36	4,00.35	92,33.77

Expenditure of the Several Provincial Governments for the Year ended 31 March, 1937

In Lakhs of rupees

Heads of expenditure	Madras	Bombay	Bengal	United Provinces	Punjab	Burma	Bihar	Central Province and Berar	North-West Frontier Province	Assam	Orissa	Sind	Total Provincial Governments
Direct demand on the revenue	1,22.71	1,23.88	92.92	1,31.09	73.64	1,32.27	35.55	55.83	7.87	35.05	14.58	26.25	8,69.08
Forest and other capital outlay charged to revenue	3.02	0.49	0.20	0.33	4.94	0.65	0.31	0.65	...	0.44	0.17	0.03	11.02
Railway (revenue account)	...	...	...	0.07	...	...	...	...	...	0.44	...	...	0.51
Irrigation (revenue account)	1,23.54	49.20	31.16	1,05.70	1,34.24	30.93	11.76	27.70	14.54	0.62	13.53	1,65.23	7,03.70
Irrigation capital outlay (charged to revenue)	2.31	...	...	-0.70	...	...	...	0.14	...	...	0.04	...	1.78
Debt services	-0.57	1,40.45	28.15	61.52	-13.28	18.37	5.87	9.91	0.63	16.81	-0.61	7.74	2,98.44
Civil administration—													
General administration	5,07.38	1,00.32	1,31.00	1,48.40	1,04.75	96.03	61.89	66.40	20.92	28.41	25.30	20.93	10,77.21
Administration of Justice	92.26	61.05	97.38	69.53	51.63	53.08	34.83	26.27	7.44	9.72	6.38	11.03	5,22.23
Police	1,58.04	1,39.98	2,26.32	1,64.93	1,29.58	1,49.93	69.91	59.03	32.42	30.17	21.88	38.88	12,18.03
Education	2,55.61	1,68.55	1,31.53	2,05.19	1,57.17	77.66	68.76	61.61	21.18	34.66	25.45	27.55	12,18.86
Medical	90.60	40.41	49.45	83.24	44.83	38.92	20.82	14.61	6.99	13.68	7.82	7.10	3,70.77
Public Health	23.75	22.45	34.28	21.80	10.99	9.94	10.09	3.58	1.53	7.10	2.03	2.07	1,49.89
Agriculture	41.77	21.84	26.61	35.17	55.10	17.03	18.25	15.97	8.05	7.89	3.03	7.88	2,57.23
Industries	22.40	6.48	14.33	14.58	14.33	1.49	8.63	2.83	0.15	3.24	1.45	0.59	89.56
Other departments	85.53	42.99	51.44	90.81	83.12	36.91	19.72	10.50	10.41	6.11	3.97	6.63	3,38.04
Total	10,37.95	5,91.10	7,63.83	7,19.65	3,75.45	4,80.97	3,12.57	2,60.80	1,05.09	1,37.38	97.39	1,23.56	52,41.92
Civil Works	1,34.28	1,03.94	93.18	68.70	1,53.50	96.44	43.27	59.02	33.94	61.08	16.45	11.89	8,98.69
Miscellaneous	1,55.03	1,61.83	1,62.72	1,42.90	1,33.06	1,38.93	63.27	67.14	16.74	37.73	14.92	25.34	11,24.93
Total expenditure	15,77.37	11,99.47	11,74.16	12,29.26	10,83.53	8,98.63	4,76.03	4,81.25	1,73.82	2,92.16	1,65.56	3,60.01	91,55.07
Total revenue	15,53.64	12,39.80	12,14.39	11,92.00	11,27.06	9,29.05	4,67.93	4,70.74	1,75.83	2,53.37	1,70.35	4,00.36	92,33.77
Surplus (+), Deficit (-) of each Government	-19.33	+40.83	+40.23	-37.26	+48.61	+30.37	-18.10	-10.53	-4.49	-38.79	+14.80	+40.31	+78.70

CHAPTER V

LOCAL FINANCE IN INDIA

A field of the administration of India profoundly affected by the Reforms of 1919 was that of Local Government. The principal Local Bodies are Municipal Boards in the urban areas and District Boards in the rural areas. Their sources of income and items of expenditure are different from those of the Central and Provincial Governments.

§ 1. MUNICIPAL FINANCE

There are in India about 781 municipalities with over 21 million people resident within their limits.

Sources of Municipal Revenue

The income of all the municipal boards put together comes to about 40 crores of rupees. Two-thirds of this income is derived from rates and taxes and the remaining 1/3rd. from municipal property, contribution out of provincial revenues and miscellaneous sources.

(1) *Taxes on Trade*--Municipal Boards levy several taxes on trade, as for example, octroi duty, terminal taxes, tolls etc. Of these *octroi duties* are the most important. They are levied on goods brought into the area of a municipal board from outside. They are very much favoured by the municipalities because their incidence is easily shifted and it is very difficult to determine on which class the burden ultimately falls. Moreover, its collection through the agency of the railways has removed all the administrative difficulties inherent in a system of octroi. But they have aroused much opposition in the public.

They offend against all the canons of taxation. Their incidence is uncertain. The collection and the refund system put the taxpayer to a great deal of inconvenience. When imposed on necessities for existence, as they generally are, they do not proportion the burden to the means of the payer. Finally, the expenses of collection and the facilities for fraud and evasion are disproportionately large. In view of these great shortcomings of the measure, it is being gradually substituted by terminal taxes and tolls. The former are collected by railway authorities on goods received by train and the latter, on goods received by roads.

(2) *Taxes on Property*—Municipal boards levy taxes on property as well, e. g., taxes on houses and their sites. The Indian Taxation Enquiry Committee suggest that the town property which benefits largely from municipal activities should be subjected to increased assessment. In many cases no tax is levied on the site. It might be expected to bring appreciable income.

(3) *Taxes on Persons*—The example of such taxes are (a) taxes on circumstances, (b) taxes on pilgrims, (c) terminal taxes on passengers and (d) taxes on menials and servants.

(4) *Fees and Licenses*—Fees are levied for specific services rendered by the municipality, e. g., scavenging fee. Sometimes they partake the nature of luxury taxes and sometimes they are levied for the purposes of regulation such as licenses for music, vehicles and dogs. License fees are also charged for carrying on offensive and dangerous trades.

(5) *Rates*—Rates are the prices charged by the municipal board for some services rendered by it. Of these, the water rate is the most important. Lighting rate is another example.

(6) *Grants From the Government*—Besides the above taxes and rates, the scanty funds of municipali-

ties are swelled by the Government grants which are annual as well as occasional.

Items of Municipal Expenditure

The functions of municipalities are divided under Public Safety, Health, Convenience and Instruction. The most important item of expenditure is the water supply, drainage and conservancy. Public instruction comes next in importance and public works follow in order. The next item of expenditure is general administration and collection of taxes. Moreover, municipalities have to borrow money every now and then from the Government or from the general public, to carry out such large projects as water supply, drainage works etc., and have to pay interest on loans. Expenditure on public safety like lighting, police, fire, etc., is also important. Money is also spent on hospitals, dispensaries and vaccinations, on markets, gardens and sanitation.

§ 2. FINANCES OF DISTRICT BOARDS

The duties and functions assigned to municipalities in urban areas are assigned to district and local boards in rural areas. In almost every district of British India, there is a board subordinate to which are two, or more, sub-district boards, while in Bengal, Madras, Behar and Orissa, there are also union committees.

Sources of Boards' Revenue

The most important item of revenue is provincial rates or sur-charges on land, which represent a proportion of the total income varying from 25% in Bombay to 63% in Behar and Orissa. The land cesses are collected along with the land revenue. They are levied at a flat rate and, therefore, inflict greater injury on the poor as compared to the rich. But still they are not opposed very much since the proceeds are applied for the benefit of the properties which profit by the activities of local boards. Civil works are another source of income.

Items of Board's Expenditure

The most important item of expenditure is education which has come remarkably to the front within the last three years. Civil works like roads and bridges are the next important objects of expenditure. Medical relief shares with education, though in a less degree, the lion's shares of the available revenue.



FINANCES OF DISTRICT BOARD

*Revenue and Expenditure of District and Local
Boards in British India.*

Income (excluding balances)	1915-16	1934-5	Expenditure	1915 16	1934 5
Provincial rates	3.39	5.39	Education ..	1.82	6.08
Civil Works	1.43	2.06	Civil Works	4.16	4.05
Other sources ...	2.68	8.72	Sanitation, Hospitals, etc	70	2.01
Total ...	7.50	16.17	Debt and Miscell- aneous ...	1.32	3.78
	Rs a p	Rs a p			
Incidence per head	0 5 1	0 9 8	Total ..	8 00	15.92